Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
High-Cost Universal Service Support	)	WC Docket No. 05-337
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	
Lifeline and Link Up	)	WC Docket No. 03-109
	)	
Universal Service Contribution Methodology	)	WC Docket No. 06-122
	)	
Numbering Resource Optimization	)	CC Docket No. 99-200
	)	
Implementation of the Local Competition	)	
Provisions of the Telecommunications Act of 1996	)	CC Docket No. 96-98
	)	
Developing a Unified Intercarrier Compensation	)	
Regime	)	CC Docket No. 01-92
	)	
Intercarrier Compensation for ISP-Bound Traffic	)	CC Docket No. 99-68
	)	
IP-Enabled Services	)	WC Docket No. 04-36
	)	

COMMENTS OF BROADVIEW NETWORKS, INC., CAVALIER TELEPHONE, NUVOX, AND XO COMMUNICATIONS, LLC

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COMMENTS OF BROADVIEW NETWORKS, INC., CAVALIER TELEPHONE, NUVOX, AND XO COMMUNICATIONS, LLC

Broadview Networks, Inc., Cavalier Telephone, NuVox, and XO Communications, LLC (hereinafter referred to as "Joint Commenters"), through counsel, hereby provide their comments in response to the Order on Remand and Report and Order and Further Notice of Proposed Rulemaking issued by the Federal Communications Commission ("Commission") in the above-captioned proceeding on November 5, 2008.[1]

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[1] *In the Matter of High Cost Universal Service Support, et al.,* WC Docket No. 05-337, *et al.*, Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, FCC 08-262 (rel. Nov. 5, 2008).

I. INTRODUCTION AND SUMMARY

The Joint Commenters commend the Commission on its decision to seek further input from consumers and service providers regarding potential comprehensive reform of the intercarrier compensation and universal service fund ("USF") systems. While the Joint Commenters generally agree that reform is needed, precisely what the reforms are and how they are implemented is critical. The revenue at issue is important lifeblood to most local exchange carriers ("LECs"), and a material misstep in the reform plans could have disastrous consequences. The proposed intercarrier compensation reform plan offered by the Chairman, for example, would have the effect of reducing revenues of non-RBOC LECs by 10% on average; worse yet, their free cash flow ("FCF") would drop by an estimated approximately 38%. Although the Chairman's plan pays lip service to a 10-year transition plan, the truth is that the adverse impact is heavily front-loaded, and most of the damage would be inflicted during the first two years of the plan. This would present a formidable problem for affected businesses during the best of times, but as the nation enters a severe recession, the possibility exists that the challenge to replace lost revenue would prove insurmountable. The Commission was wise to step back and invite the public to comment on the specifics of the radical reforms offered up by the Chairman.

Having now had an opportunity to review the Chairman's proposal, the Joint Commenters believe that significant parts of it make sense, and adoption of those discrete portions would have the effect of correcting significant problems with the current system. Specifically:

Resolution of the Phantom Traffic Problem. The Joint Commenters support the proposal to adopt a major portion of the USTelecom proposal to revamp the Commission's rules for call signaling to preclude service providers from disguising or misidentifying terminating traffic. This change will immediately and single-handedly eliminate most of the access charge arbitrage that is oft cited as the most important reason for intercarrier compensation reform.

Uniform Terminating Rate. Establishing an ultimate policy goal of harmonizing all intercarrier compensation at a single terminating rate is laudable. The Joint Commenters have long supported the notion of "a minute is a minute," and that over time all traffic should be terminated at a single rate. However, as discussed below, the Chairman's Draft Proposal falls short in the implementation of this principle by ignoring the statutory role of state commissions, overly truncating the transition period, and prescribing a short run incremental cost methodology that would deny LECs a fair return on their investments, thereby retarding broadband deployment.

Replacement of the Revenue-Based USF Contribution Model. Many interested parties submit that the use of interstate revenues as a basis to fund USF is no longer sustainable. As the industry moves to broadband and bundled products, those parties state that the declining assessable revenue base requires that a new model be adopted. For the Joint Commenters, however, the proposed hybrid numbers/connections based system creates as many problems as it solves and, thus, we urge the Commission to take a closer look at what contribution system should be created if it decides to move forward to replace the old one.

Unfortunately, while the draft plan circulated by the Chairman takes important steps in the right direction, the potential benefits of the proposal are overwhelmed by several critical shortcomings. The Joint Commenters support the effort to move forward with comprehensive reform of both the intercarrier compensation and universal system systems, but only if the failures of the Chairman's plan are addressed and fixed. In the view of the Joint Commenters, the draft proposal should be revised as follows:

Alternative Approach to Harmonizing Interstate and Intrastate Access Charges. The Chairman's plan to effectively preempt the traditional state commission prerogative to establish intrastate access charges is legally suspect, and the Commission would be better advised to request that a Federal-State Joint Board resolve the issue of how to close the gap between interstate and intrastate switched access rates. If the Commission elects to proceed with the proposed preemption, however, it is critical that the proposed transition period for driving intrastate access charges to interstate levels be revamped to avoid rate shock. The Joint Commenters propose that LECs be required to reduce the differential between their interstate and intrastate access charges by 20% per year beginning January 1, 2010, so that all switched access traffic is terminated at existing interstate terminating switched access rates at the end of a reasonable 5-year transition period.

Retention of TELRIC as the Basis for Establishing the Uniform Termination Rate. While the Joint Commenters support the notion of migrating to a uniform rate for traffic termination, the Chairman's radical proposal to replace the current TELRIC methodology for establishing reciprocal compensation rates with what effectively would be a short-run incremental cost standard would deny LECs an opportunity to earn a fair return and deter future investment in broadband networks. The Commission instead should reaffirm that TELRIC is the appropriate cost methodology to be used by state commissions in establishing uniform termination rates, and issue a Further Notice of Proposed Rulemaking ("FNPRM") if it believes that reforms to TELRIC are advisable. The FNPRM also can be used to establish a transition plan for migration from the unified interstate/intrastate switched access rate to the uniform local/long distance termination rate.

Reject Proposals to Change the Interconnection Architecture Rules. Abandoning interconnection architecture rules that have been established through a decade of FCC rulemaking and hundreds of state commission implementation proceedings simply is not necessary to accomplish intercarrier compensation reform. It is hard to reconcile the contention of the Chairman's Draft Proposal that IP networks will soon dominate with its plan to create new TDM-based interconnection rules that would not become effective for 10 years. The proposed changes to interconnection architecture are simply irrelevant and unnecessary and should be eliminated from any reform plan.

Avoid Prospective Classification of IP-PSTN Traffic as an Information Service. Given that IP-PSTN traffic entails a net protocol conversion, the Chairman's Draft Proposal observes correctly that VoIP providers can elect to terminate IP-PSTN traffic at reciprocal compensation rates under current rules. The Commission should refrain from classifying IP-PSTN traffic as information services for all purposes however. Specifically, the Commission should take this opportunity to announce a change of law, and treat IP-PSTN traffic as telecommunications service prospectively for purposes of both interconnection and traffic termination.

The Joint Commenters support reform of the intercarrier compensation and universal service systems, but the Commission should take care not to adopt reforms based on insufficient evidence and should eschew those reforms that would benefit a few RBOCs to the detriment of nearly all other interested parties. Reform must be carefully targeted, competitively neutral, and phased in based on market realities. The Joint Commenters respectfully suggest that our proposed modifications to the Chairman's Draft Proposal accomplish these objectives.

II. THE COMMISSION NEED NOT RESOLVE ALL ASPECTS OF INTERCARRIER COMPENSATION AND UNIVERSAL SERVICE REFORM IN A SINGLE ORDER

The Commission clearly is correct that developments in the telecommunications industry over the past decade have "challenged the outdated regulatory assumptions underlying [the Commission's] universal service and intercarrier compensation regimes, forcing [it] to reassess [its] existing approaches."[2] Runaway growth in the federal universal service fund is cause for a thorough re-examination of both the contribution and distribution sides of USF programs. Similarly, holes in call signaling rules have combined with a patchwork of intercarrier compensation rates to create undesirable levels of traffic termination arbitrage. The Joint Commenters agree that the Commission's rules should be modified to modernize both programs, and to correct these problems.

That said, special caution is required due to the fact that the overall economy plunged into deep recession literally as the Chairman's Draft Proposal was being developed. The Commission cannot ignore the current macro-economic environment. A time of economic contraction, and unprecedented seizure of the credit markets, is not a moment to make flash-cut changes that materially disrupt long-standing revenue streams. The onset of recession certainly is not a reason to abandon reform efforts, but it is cause for special caution, deliberation, and attention to a reasonable transition. Thus, the Joint Commenters urge the Commission to make targeted changes in the areas that clearly need fixing – and to phase them in at a reasonable pace – but to refrain from adopting changes that would produce catastrophic rate shock or that would lock the industry in to a long-term plan that may not adequately take into account changes in technology and network architecture that are being developed and implemented today.

A. Several Discrete Intercarrier Compensation Issues Can And Should Be Resolved Immediately

Although the Commission should not radically revamp the intercarrier compensation system, that does not mean that significant problems cannot be addressed now. The most serious problems with the existing system can be remedied easily and immediately, without causing major disruption to affected carriers. The Chairman's Draft Proposal states that

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[2] Order on Remand and FNPRM, at ¶ 39.

intercarrier compensation reform is required because of distortions caused by "regulatory arbitrage" in the marketplace attributable to the existence of different rates for similar call termination functions.[3] The Chairman's Draft Proposal identifies three primary categories of such regulatory arbitrage: charging reciprocal compensation rates established for local traffic termination for dial-up calls destined to Internet Service Providers ("ISPs"), billing for traffic when it arrives with insufficient identifying information, and the practice of LECs entering into agreements with service providers that generate large volumes of incoming calls to substantially increase the number of calls sent to the LEC.[4] One of these problems -- the issue of dial-up traffic to ISPs – has already been resolved. As required by the D.C. Circuit, the Commission has responded to the Court with a sustainable legal rationale in support of its existing rules applicable to such ISP-bound calling.[5] Thus, the Commission's existing rules that assign an extremely low rate to out-of-balance traffic are preserved absent further action of the Court or Commission, and any incentive for uneconomic arbitrage of such ISP-bound calling is eradicated. With respect to the remaining sources of arbitrage that concern the Commission, action can be taken immediately to remedy them.

1. *Resolution of the "Phantom Traffic" Problem.* The Joint Commenters agree with the observation in the Chairman's Draft Proposal that the current disparity in intercarrier compensation rates creates both an opportunity and an incentive to misidentify or conceal the source of traffic in order to avoid or reduce payments to other service providers.[6] It is obviously true that establishing a single uniform rate for all terminating traffic would

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3 Chairman's Draft Proposal, at ¶ 178.

4 *Id.*, at ¶¶ 179, 185.

5 Order on Remand and FNPRM, at ¶¶ 6-16.

6 Chairman's Draft Proposal, at ¶ 326.

eliminate the incentive for such deceptive behavior. But it is not necessary to go that far in order to solve the problem. An equally effective solution is to make such traffic misidentification impossible by modifying the Commission's rules governing call signaling.

The Joint Commenters have long advocated that the current loopholes in the Commission's call signaling rules be closed. We first outlined the changes necessary in 2006 when commenting on aspects of the so-called Missoula Plan. We recommended rule changes then that would require all carriers to generate and pass along CPN and other jurisdictional-related signaling information without alteration.[7] Earlier this year, we filed in support of a detailed "phantom traffic" eradication proposal filed by USTelecom.[8] Specifically, we supported USTelecom's proposed rules dealing with the population and transmission of call signaling information.[9] We reiterated our support only last month when we wrote that "[t]here is an industry consensus that relatively simple modifications to rules governing call signaling and routing would render ... access avoidance opportunities obsolete", and again endorsed the majority of the USTelecom-suggested rule changes.[10]

The Joint Commenters were pleased that the Chairman's Draft Proposal would adopt the USTelecom rule changes pertaining to the population and transmission of call signaling information. Specifically, the rule changes proposed therein would effectively prohibit any altering or stripping of SS7 CPN, MF ANI, or CN signaling information and obligate

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7 Comments of Broadview Networks, Nuvox Communications, One Communications Corp., and XO Communications, CC Docket No. 01-92 (filed Dec. 6, 2006).

8 Letter of Thomas Cohen, Counsel to NuVox, *et al.*, to Marlene Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-92 (filed Mar. 11, 2008) ("*Mar. 11th Phantom Traffic Ex Parte*").

9 *Id.*, at 3.

10 Letter from Brad Mutschelknaus, Counsel to Broadview Networks, Inc., *et al.*, to Hon. Kevin Martin, Chairman, Federal Communications Commission, CC Docket No. 01-92, (filed Oct. 22, 2008).

intermediate service providers to pass, unaltered, whatever signaling information they receive.[11] By requiring that all calls be populated with call origin identifying information, and expanding such requirements to include intrastate calling and MF-based traffic, the draft proposal would deny unscrupulous service providers any opportunity to avoid access charge obligations by employing strategies which disguise the jurisdictional character of traffic delivered to LECs for termination. In fact, the Chairman's Draft Proposal includes a reform which enables terminating LECs to enforce these expanded call signaling requirements by permitting them to charge the highest available rate when terminating traffic that lacks any of the required call signaling information.[12]

It also was heartening to see that the Chairman's Draft Proposal refrained from adopting portions of the USTelecom proposal which "overshot" and proposed rule changes that had no relation to the problem of traffic misidentification. Specifically, the draft order properly declined to adopt USTelecom's recommendations relating to traffic routing, local number portability queries, and providing incumbent local exchange carriers ("ILECs") with certain rights with regard to Sections 251 and 252 negotiation and arbitration procedures.[13] Of particular note, the Joint Commenters have previously opposed USTelecom's proposed requirement permitting ILECs to request negotiation and arbitration pursuant to Section 252 with other carriers with which the ILECs exchange traffic.[14] That part of USTelecom's proposal is not legally permissible, since ILECs do not qualify as requesting carriers under Section 251(c) and thus cannot invoke the negotiation/arbitration provisions of Section 252.

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11 Chairman's Draft Proposal, at ¶¶ 330-333.

12 *Id.*, at ¶¶ 336-37.

13 *Id.*, at ¶ 342.

14 *Mar. 11th Phantom Traffic Ex Parte*, at 3-4.

Thus, the Joint Commenters endorse the rule modifications intended to end the so-called "Phantom Traffic" problem outlined in the Chairman's Draft Proposal. Once implemented, these technical fixes would resolve the Phantom Traffic problem and enable traffic to be billed correctly.

2. *Curbing Uneconomic Traffic Stimulation.* The Commission repeatedly has expressed concern about business plans that are designed to generate substantial growth in access traffic from long-distance companies. Last year, the Commission tentatively concluded that it must revise its rules so that tariffed rates remain just and reasonable even if a carrier experiences significant increases in access demand, and issued a Notice of Proposed Rulemaking ("NPRM") soliciting comment on several possible approaches to throttle alleged access stimulation strategies.[15] Numerous parties commented, and suggested or supported multiple fixes for the problem. The record is complete, and the Commission can now act in WC Docket No. 07-135 to select the solution that it deems most appropriate to control traffic stimulation, including targeting any solution to the wrongdoers.

3. *Resolving the Regulatory Treatment of IP-PSTN Traffic.* The Chairman's Draft Proposal does not describe IP-PSTN traffic as a source of regulatory arbitrage, but the fact is that such traffic is the "elephant in the room" on the topic of differential call termination rates. Proponents of comprehensive intercarrier compensation reform have complained loudly that many VoIP providers complete interexchange IP-PSTN calls over local trunk groups at reciprocal compensation rates, and thereby bypass the switched access charge system. VoIP providers, by contrast, claim that they qualify as Enhanced Service Providers ("ESPs"), and that the ESP Exemption from the application of switched access charges entitles them to terminate

15 *Establishing Just and Reasonable Rates for Local Exchange Carriers,* Notice of Proposed Rulemaking, WC Docket No. 07-135 (rel. Oct. 2, 2007).

traffic at reciprocal compensation rates. The legal uncertainty in this area has led to the filing of competing petitions for forbearance – one which asks that VoIP traffic be made subject to switched access charges and the other requesting that it be made exempt.[16]

The treatment of this critical issue in the Chairman's Draft Proposal is not a model of clarity. It proposes to classify services that originate calls on IP networks and terminate calls on circuit-switched networks (*i.e.,* IP-PSTN services) as "information services."[17] The Proposal finds that such IP-PSTN traffic qualifies as "enhanced" today because such traffic entails a net protocol conversion between end users.[18] The Chairman's Draft Proposal does not go on to expressly state that the classification of IP-PSTN traffic as "enhanced" entitles it to claim an exemption from switched access charges however. Instead, that result is suggested in a footnote where it is revealed that "IP/PSTN traffic ultimately [would] be subject to the final uniform reciprocal compensation rates established pursuant to the methodology adopted in this order," although "the status quo for this traffic [would be maintained] during the transition."[19]

Thus, it appears that the Chairman's Draft proposes to find that IP-PSTN traffic currently qualifies for the ESP Exemption from the application of switched access charges, but that such IP-PSTN traffic will be made subject to the uniform reciprocal compensation rate after a final uniform rate is determined and implemented. The Joint Commenters suggest that,

16 *See FEATURE GROUP IP Petition for Forbearance Pursuant to 47 U.S.C. § 160(c), from Enforcement of 47 U.S.C. § 251(g), Rule 51.701(a)(1), and Rule 69.5(b),* WC Docket No. 07-256 (filed Oct. 23, 2007); *Petition of the EMBARQ LOCAL OPERATING COMPANIES for Limited Forbearance Under 47 U.S.C. § 160(c) from Enforcement of Rule 69.5(a), 47 U.S.C. § 251(b), and the Commission Order on the ESP Exemption,* WC Docket No. 08-8 (filed Jan. 11, 2008).

17 Chairman's Draft Proposal, at ¶ 209.

18 *Id.*

19 *Id.*, at n. 564.

alternatively, the Commission adopt an approach regarding the treatment of IP-PSTN traffic that is consistent with the proposal outlined herein.

Since 1998, when the Commission issued a Report to Congress on Universal Service in which it for the first time engaged in a discussion whether certain types of IP-enabled applications, specifically, IP-voice telephony, could be categorized "telecommunications" or "telecommunications services" under the Communications Act or whether those services fell outside those categories,[20] the Commission has reached no definitive conclusion regarding the regulatory classification of IP-based telephony, leaving that basic question unresolved. In the absence of a definitive pronouncement by the Commission on the regulatory treatment of IP-PSTN traffic, originating carriers have self-determined whether their IP-PSTN traffic is telecommunications services or information services based on the type of facilities they have chosen to route this traffic.

The Commission's rules provide VoIP providers with the opportunity to connect to the PSTN over local trunks, but do not preclude them from treating their services as interexchange telecommunications and terminating them over switched access trunks. In the Joint Commenters' experience, many VoIP providers have chosen to terminate their traffic over switched access trunk groups. When such IP-PSTN traffic is presented for termination over switched access trunk groups, LECs cannot distinguish the calling from any other interexchange traffic and, accordingly, routinely charge switched access rates for terminating the traffic. Conversely, since VoIP providers' traffic entails the net protocol conversion that has permitted service providers to elect to be treated as ESPs, many other VoIP providers have elected to route

20 *Federal-State Joint Board on Universal Service,* Report to Congress, 13 FCC Rcd 11501 (1988).

their IP-PSTN traffic for termination over local trunks. Under such circumstances, the traffic has properly been treated as information services subject to reciprocal compensation (and exempt from the payment of access charges).

The Joint Commenters suggest, however, that the Commission change its policy prospectively, and rule that going forward IP-PSTN interexchange service providers will be billed switched access charges regardless of how such traffic is routed. The Commission should clarify that the practice of paying reciprocal compensation when non-local IP-PSTN traffic is routed over local trunk groups will no longer be appropriate and proper under its rules and that switched access charges will apply whether service providers elect to route interexchange IP-PSTN traffic over switched access trunk groups or local facilities. Importantly, the Commission should state expressly that this modification of its policy constitutes a "change of law", in order to avoid needless litigation over VoIP service provider practices during the lengthy period in which the Commission chose not to address the regulatory treatment of IP-PSTN traffic. This formulation promotes the Commission's stated goal to treat all traffic consistently for compensation purposes and, at the same time, forestalls a new round of disputes and litigation.

Our proposed alternative approach recognizes that the existence of net protocol conversion embedded in IP-PSTN traffic has enabled VoIP providers to opt to treat their traffic as "enhanced" in the past, but seeks going forward to recognize that such traffic in most instances would be better treated as "telecommunications." As a general matter, where an entity makes a general offering for a fee of a service that consists of the transmission of real-time voice communications, that service is properly classified as a common carrier telecommunications service under the test established in *NARUC I*.[21]

> We reject those parts of the Orders which imply an unfettered discretion in the Commission to confer or not confer common carrier status on a given entity, depending upon the regulatory goals it seeks to achieve ... A particular system is a common carrier by virtue of its functions, rather than because it is declared to be so.[22]

Basic voice telephone service always has been viewed as the classic common carrier offering regardless of the underlying physical characteristics of the network or the transmission protocols used. The introduction of Internet Protocol technology is most accurately characterized as a continuation in the evolution of basic telephone service along the lines forged previously by the introduction of SS7, Intelligent Network, and Advanced Intelligent Network technologies. Providers should be afforded the option to make a showing to the Commission that their particular IP-PSTN service differs from standard voice telephone service in such a substantial and material way that it is properly classified as an information service[23] but, in the absence of such proof, all IP-PSTN traffic should be subject going forward to standard common carrier telecommunications regulation, including the payment of switched access charges.

Notwithstanding the foregoing, should the Commission nevertheless categorize all IP-PSTN traffic as information services, – which it should not – it is essential that the Commission make clear that its classification of IP-to-PSTN traffic as an information service for purposes of assessment of intercarrier compensation does not undermine the rights of facilities-based competitive local exchange carriers ("CLECs") to obtain UNEs and interconnection

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21 *National Ass'n of Regulatory Util. Comm'rs v. FCC*, 525 F.2d 630 (D.C. Cir. 1976) ("*NARUC I*").

22 *Id.*, 525 F.2d at 644.

23 This showing could take the form of a petition for declaratory ruling or a Section 10 forbearance petition.

pursuant to Sections 251(c)(2) and (3) when providing IP-based services to end users or other carriers. CLECs are dependent upon access to cost-based interconnection and UNEs to deliver bundled IP-based services to literally millions of end user and carrier customers today, and great care must be taken not to undermine that critical regime.

One way to accomplish this would be for the Commission to clarify that the regulatory framework adopted for IP-PSTN services is the same as has been previously adopted for broadband Internet access services offered by wireline facilities-based providers.[24] In the *Broadband Classification Order*, the Commission classified wireline broadband Internet access service as an information service.[25] Critically, however, the Commission permitted facilities-based wireline carriers to offer broadband Internet access transmission arrangements for wireline broadband Internet access services on either a common carrier or a non-common carrier basis.[26] Thus, wireline carriers were given the option of electing to offer the transmission input to their Internet access services as a telecommunications service, provided they did so on a common carrier basis and complied with regulatory requirements applicable to the provision of telecommunications services.[27] This treatment was consistent with a long history of permitting carriers to decide whether to offer their services on a common carrier or non-common carrier basis.[28] It should be adopted with respect to IP-PSTN services as well if the Commission otherwise decides to declare IP-PSTN traffic to be an information service. Such an approach serves the public interest by "providing all wireline broadband providers the flexibility to offer

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24 *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, CC Docket Nos. 02-33, *et al.* (rel. Sept. 23, 2005) ("*Broadband Classification Order*").

25 *Broadband Classification Order*, at ¶ 4.

26 *Id.*, at ¶¶ 5, 89-95.

27 *Id.*, at ¶ 90.

28 *Id.*, at n. 280.

these services in the manner that makes the most sense as a business matter and best enables them to respond to the needs of consumers in their respective service areas"[29] and ensures that essential interconnection is available where required to provide IP-PSTN services.

B. The Commission Should Initiate An FNPRM To Consider Whether Broader Reform Is Required

The actions recommended above would resolve the arbitrage opportunities identified in the Chairman's Draft Proposal. The Joint Commenters believe that the Commission's current consideration of the topic could conclude with those actions at this time. However, we are mindful of the Joint Statement of Commissioners Copps, Adelstein, Tate, and McDowell indicating a "growing measure of consensus" in favor of "moving intrastate access rates to interstate access levels over a reasonable period of time,"[30] and the request for "particular comment" on the proper methodology for establishing uniform terminating rates in the future.[31] Accordingly, the Joint Commenters suggest that the actions summarized above be taken immediately to resolve current problems with the intercarrier compensation system, and that the Commission initiate an FNPRM to consider what longer-term reforms are required and the form they should take. In particular, consideration of the cost standard to be used in establishing a uniform terminating intercarrier compensation rate should be referred to future proceedings during which expert debate can occur. That topic is both critically important and extraordinarily complex. While the Joint Commenters greatly appreciate this opportunity to comment on the incremental cost standard proposed in the Chairman's Draft Proposal – and we do so preliminarily in Section IV, *infra* – the truth is that additional proceedings are needed to explore

29 *Id.*, at ¶ 89; *see also* ¶ 94.

30 Order on Remand and FNPRM, Joint Statement of Commissioners Copps, Adelstein, Tate and McDowell.

31 Order on Remand and FNPRM, at ¶ 41.

the topic in depth, analyze the potential impacts on the industry, and consider proposed alternative approaches.

III. ANY COMPREHENSIVE INTERCARRIER COMPENSATION REFORM PLAN ADOPTED BY THE COMMISSION MUST BE CONSISTENT WITH THE SCOPE OF THE COMMISSION'S AUTHORITY UNDER THE ACT

The Chairman's Draft Proposal correctly states that the Commission has authority to reform intercarrier compensation with respect to interstate access services pursuant to Sections 152(a), 201, and 202 of the Act.[32] Section 152(a) establishes the Commission's jurisdiction over all interstate and foreign communication by wire or radio ... which originates or is received within the United States"[33] and Sections 201 and 202 grant the Commission authority to ensure that the rates for such services are just, reasonable, and not unjustly or unreasonably discriminatory.[34] The Chairman's Draft Proposal also correctly notes that Section 332 of the Act[35] affords the Commission authority over the rates charged by CMRS providers.[36] The Chairman's Draft Proposal fails to acknowledge, however, that Congress intended that the states have general authority over intrastate communications, including intrastate access services, a domain the Commission can lawfully step into only in the most limited circumstances. As explained below, the Chairman's Draft Proposal does not offer legitimate grounds for the Commission to preempt the states' authority to establish intrastate access charges. Moreover, Section 251(b)(5)[37] does not afford the Commission a lawful means to circumvent the

32 Chairman's Draft Proposal, at ¶ 208.

33 47 U.S.C. § 152(a).

34 47 U.S.C. §§ 201, 202.

35 47 U.S.C. § 332.

36 Chairman's Draft Proposal, at ¶ 208.

37 47 U.S.C. § 251(b)(5).

jurisdictional parameters set out in the Act. Thus, the regulatory framework for intercarrier compensation contained in the Chairman's Draft Proposal is not consistent with the distribution of regulatory authority between the Commission and the states and therefore should not be adopted by the Commission.

A. Section 152(b) Of The Act Reserves To The States Exclusive Jurisdiction Over Intrastate Access Services

The framework of the current access charge regime was instituted over twenty-five years ago. In 1980, the Commission, in its *MTS and WATS Market Structure* proceeding, retained the role of reviewing local exchange carriers' *interstate* access charges assessed for the origination and termination of interexchange services, leaving to the states the same task with respect to *intrastate* access charges. The Commission recognized that how it chose to regulate interstate access charges could, at best, serve as a model the states *might* choose to emulate, not one they could be forced to adopt:

> The present statute does not empower us to establish access service compensation arrangements for all interexchange services. Any arrangement we prescribe necessarily must be confined to interstate and foreign communications. That prescribed arrangement could be used as a model for intrastate interexchange access service compensation arrangements *if the states chose to follow it.*[38]

In its 1983 Third Report and Order in the *MTS and WATS Market Structure* proceeding, the Commission expressly refused to preempt state regulation of intrastate access charges, again recognizing the limits placed on it under the statute and referring to its reasoning just three years' earlier:

> SBS has proposed that we preempt state regulation of intrastate access charges and others have suggested that we

[38] *In the Matter of MTS and WATS Market Structure,* Second Supplemental Notice of Inquiry and Proposed Rulemaking, CC Docket No. 78-72, 77 F.C.C.2d 224, 232, ¶38 (1980) (emphasis supplied; subsequent history omitted).

> delegate responsibility for interstate access charges to the state commissions. We rejected somewhat similar suggestions when we adopted the Second Supplemental Notice.[39]

The stumbling block for the Commission, which it properly recognized in 1980 and 1983, is the same which exists unchanged in the statute today. Section 152(b) of the Act provides, in relevant part, that

> *nothing* in [the Act] shall be construed to apply to or to give the [Federal Communications] Commission jurisdiction with respect to (1) charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any caller . . ..[40]

Section 152(b) is well established as reserving to the states the exclusive jurisdiction over all intrastate services except where Congress has clearly carved out exceptions, such as Section 332(c)(3), which gives the Commission exclusive jurisdiction over rates and entry of wireless carriers "[n]otwithstanding sections 2(b) and 221(b)."[41] Despite the Section 332(c)(3) exception and conferral of exclusive jurisdiction over the rates for wireless services in the federal agency, however, the U.S. Court of Appeals for the Eleventh Circuit concluded that the scope of the term "rates" in Section 332(c)(3) was not so broad as to prevent the states from regulating line items on wireless customers bills.[42] This case underscores that the wiggle room of the Commission to ignore the limits placed on its jurisdiction relative to the states is very narrow indeed.

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39 *MTS and WATS Market-Structure,* Third Report and Order, 93 FCC 2d 241, 264, ¶69 (1983).

40 47 U.S.C. §152(b).

41 47 U.S.C. § 332(c)(3)(A).

42 *National Association of State Utility Consumer Advocates v. FCC*, 457 F. 3d 1238 (11th Cir. 2006).

Under the "new approach to intercarrier compensation" contained in the Chairman's Draft Proposal, in the first stage of a ten-year transition plan, intrastate terminating switched access rates would be reduced to the levels of interstate rates.[43] In short, the states would lose any ability to control the rates charged for terminating intrastate switched access traffic. As explained above, this approach would usurp the statutory authority expressly delegated to the states by Congress. Further, as described below, this approach would not meet the strict requirements that the Commission must satisfy to overcome the limits on its authority contained in Section 152(b).

B. The Commission Cannot Lawfully Preempt State Jurisdiction Over Intrastate Switched Access Services

Proponents of the jurisdictional framework suggested in the Chairman's Draft Proposal will no doubt argue that the Commission can lawfully preempt state authority over intrastate access services and exercise its general rulemaking authority under Section 201 to require intrastate terminating switched access rates to be reduced to the level of interstate rates.[44] These arguments misstate or ignore relevant case law and rely on inaccurate generalizations regarding the state of telecommunications technology. As such, they do not provide a legally sufficient basis for the preemption of intrastate access charge regimes.

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43 More specifically, one year from the effective date of the order, all LECs would be required to reduce their terminating intrastate access rates by 50 percent of the difference between their intrastate switched access rates and their interstate switched access rates. Two years from the effective date of the order, all LECs would be required to reduce their terminating intrastate switched access rates by the remaining 50 percent of the difference between their intrastate switched access rates and their interstate switched access rates so that their intrastate rates equal their interstate rates. Chairman's Draft Proposal, at ¶ 193.

44 *See, e.g.,* "The Commission Has Legal Authority to Adopt a Single, Default Rate for All Traffic Routed on the PSTN," attached to Letter from Donna Epps, Vice President, Verizon, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-92, *et al.* (filed Sept. 19, 2008) ("*Verizon White Paper*").

In *Louisiana Public Service Commission v. FCC*, the U.S. Supreme Court strongly reinforced the general jurisdiction of the states over intrastate communications, holding that the FCC may preempt state regulation of an intrastate matter *only* when the matter has interstate aspects as well and when it is "*not* possible to separate the interstate and the intrastate components of the asserted FCC regulation."[45] Subsequent case law has refined the so-called "impossibility exception" to allow Commission preemption of state regulation only when: (1) the matter to be regulated has both interstate and intrastate aspects, (2) Commission preemption is necessary to protect a valid federal regulatory objective, and (3) state regulation would negate the exercise by the Commission of its own lawful authority because regulation of the interstate aspects of the matter cannot be unbundled from regulation of the intrastate aspects.[46] Neither the second nor the third requirements are satisfied here.

Regarding the applicability of the impossibility exception to intrastate access services, supporters of the Chairman's Draft Proposal will likely assert that genuine intercarrier compensation reform cannot succeed unless it encompasses every class of traffic, including intrastate access traffic. They will argue, in effect, that unless the Commission preempts the states from exercising the authority specifically reserved to them by Congress in Section 152(b), the Commission will be unable to achieve the federal goal of effective intercarrier compensation reform. The extent of the Commission's legitimate objectives for intercarrier compensation reform, given the dual jurisdictional nature of telecommunications regulation in this country, however, are limited to reform for *interstate* telecommunications. The "impossibility exception"

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45 *Louisiana Public Service Commission v. FCC*, 476 U.S. 355, 375, n. 4 (1986) ("*Louisiana PSC*") (emphasis in original).

46 *Pub. Serv. Comm'n of Maryland v. FCC*, 909 F.2d 1510, 1515 (D.C. Cir. 1990), *citing Illinois Bell Tel. Co. v. FCC,* 883 F.2d 104, 113 (D.C.Cir.1989), *National Ass'n of Regulatory Util. Comm'rs v. FCC,* 880 F.2d 422, 431 (D.C.Cir.1989).

only applies to *valid* federal objectives, and thus the exception cannot be invoked to preempt the states from their otherwise valid jurisdiction over intrastate telecommunications traffic to achieve Commission objectives with respect to intrastate traffic *per se*. But this is precisely what the framework contained in the Chairman's Draft Proposal seeks to do, making the Commission regulation of *intra*state rates the objective itself, rather than a necessary means to regulate *inter*state matters.

Ironically, the Chairman's Draft Proposal summons the impossibility exception articulated in *Louisiana PSC* on grounds which are almost indistinguishable from the grounds offered by the Commission in that case (and rejected by the Supreme Court) to preempt state regulation of carrier depreciation rates. In *Louisiana PSC*, the Supreme Court found the Commission had overstepped the jurisdictional bounds set by Congress by preempting state regulation of depreciation rates and methods for equipment, plant, and other property used by telephone companies to provide both intrastate and interstate service. The Court found that Congress did not intend that regulations adopted by the Commission under the authority granted the Commission under Section 201(b) of the Act to supersede state authority over intrastate communications, whether on the subject of depreciation rates, end user rates, or otherwise. The Court explicitly rejected the Commission's argument that Congress's directive to the Commission in Section 1 of the Act to ensure efficient, *national* phone service inherently gave the Commission plenary authority over depreciation rates for equipment used for both interstate and intrastate communications because of the express jurisdictional limitations in Section 152(b). Regarding Section 152(b), the Court underscored that, "By its terms, this provision fences off from Commission reach or regulation intrastate matters--indeed, including matters 'in connection with' intrastate service."[47] Thus, in *Louisiana PSC*, a dual system for regulating depreciation rates for one set of equipment and plant was preserved.

Conversely, the *Louisiana PSC* Court noted that state regulation could only be displaced where it stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress provided the federal agency is acting *within the scope* of its congressionally-delegated activity. Given the separations process provided for in the statute and Congress's clear vision that there would be a dual jurisdiction system of telecommunications regulation, the Court did not consider depreciation rates to provide a situation justifying preemption. The subject matter here – interstate and intrastate access charges – no less than interstate and intrastate depreciation rates, is naturally subject to the dual jurisdiction framework of the Act, as the states and Commission have correctly understood it to be from the beginning.

The Supreme Court in *Louisiana PSC* went on to underscore that federal preemption would be allowed only "where it [is] *not possible to separate the interstate* and intrastate components" of the subject matter. In those narrow circumstances, the exercise of plenary federal jurisdiction and preemption of conflicting state regulation is permissible.[48] Thus, for example, the Court of Appeals for the D.C. Circuit, three years after *Louisiana PSC*, upheld the Commission's preemption of the state tariffing of inside wiring, noting that such preemption is permissible "when the states' exercise of [their] authority negates the exercise by the FCC of its own lawful authority over interstate communications."[49] The Commission and courts have affirmed other areas where interstate and intrastate aspects of services or facilities are inextricably tied together, justifying federal preemption and the assertion of exclusive

47 *Louisiana PSC*, 476 U.S. at 370.

48 *Id.*, at 375 n. 4.

49 *National Ass'n of Reg. Util. Comm'rs. v. FCC,* 880 F.2d 422, 429 (D.C. Cir. 1989).

jurisdiction by the Commission where state regulation would jeopardize Commission regulation over interstate matters.[50]

In contrast, the Commission has never recognized there is anything inextricable about interstate and intrastate access services. Each interexchange minute passed over local exchange facilities has been jurisdictionalized as one or the other for decades. The states have regulated the rates for intrastate access minutes during that entire period, and continue to do so today. The Commission has never suggested that the federal policies and objectives regarding the regulation of interstate switched access services were somehow threatened by these state actions. As discussed above, when the modern access charge regime was constructed in the early 1980s, the Commission considered and expressly rejected, on the basis of the clear divisions created by Section 152(b), arguments that it preempt state regulation of intrastate access charges.

It has been suggested that for some traffic, namely VoIP and wireless traffic, it is not realistically possible to separate intrastate calls from interstate calls and, thus, preemption of intrastate rate-setting authority is justified.[51] Even if this were true, it would not justify preempting state regulation of intrastate access services for other types of calls, such as wireline-

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50 *See, e.g., Federal-State Joint Board on Universal Service: Western Wireless Corporation (Petition for Preemption of an Order of the South Dakota Public Utilities Commission),* Declaratory Ruling, 15 FCC Rcd 15168 (2000) (preempting a state interpretation of Section 214(e)(1) of the Act that requires a new entrant to provide service throughout the service area prior to designation as an Eligible Telecommunications Carrier ("ETC") to be fundamentally inconsistent with Congress' universal service objectives as outlined in Section 254, and the Commission's policies and rules in implementing Section 254); *Illinois Bell Telephone Co. v. FCC*, 883 F. 2d 104 (D.C. Cir. 1989) (permissible for the Commission to preempt state regulation of the joint marketing of customer premises equipment used inextricably for intrastate and interstate telephone service that is inconsistent with the Commission's own joint marketing regulations); *Public Service Commission of Maryland v. FCC*, 606 F. 2d 1510 (D.C. Cir. 1990) (upholding Commission preemption of state attempts to set rates charged by local exchange carriers to interexchange carriers for disconnection of local telephone service for failure to pay interstate charges).

51 *Verizon White Paper*, at 2.

to-wireline carrier calls. But supporters do not make a convincing case for inseparability even as it applies to VoIP and wireless calls. The Commission has acknowledged that at least some VoIP providers may be able to determine the geographic end points of their subscribers' communications.[52] Specifically, in its June 2006 order imposing universal service contribution obligations on VoIP providers, the Commission explained that:

> a fundamental premise of our decision to preempt Minnesota's regulations in the *Vonage Order* was that it was impossible to determine whether calls by Vonage's customers stay within or cross state boundaries. . . . [T]o the extent that an interconnected VoIP provider develops the capability to track the jurisdictional confines of customer calls, it may calculate its universal service contributions based on its actual percentage of interstate calls. Under this alternative, however, we note that an interconnected VoIP provider with the capability to track the jurisdictional confines of customer calls would no longer qualify for the preemptive effects of our *Vonage Order* and would be subject to state regulation. This is because the central rationale justifying preemption set forth in the *Vonage Order* would no longer be applicable to such an interconnected VoIP provider.[53]

In other words, rather than muddling the distinctions between intrastate and interstate jurisdictions, technological advancements affecting VoIP services may be rendering it easier to make such distinctions.

C. Section 251(b)(5) Cannot Be Redefined To Give The Commission Jurisdiction Over Intrastate Access Services

The Chairman's Draft Proposal attempts to circumvent the statutory bar to the Commission's exercise of jurisdiction over intrastate access services explained above by bringing all traffic which touches the PSTN – including intrastate access traffic – within the

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52 *See Universal Service Contribution Methodology*, WC Docket No. 06-122, FCC 06-94 (released June 27, 2006).

53 *Id.*, at ¶ 56 (footnotes omitted).

purview of Section 251(b)(5) of the Act.[54] Under this approach, the FCC would establish the pricing methodology that state commissions would be obligated to apply (after a transition period) to set uniform intercarrier compensation rates for all traffic. As explained below, the Commission cannot lawfully redefine Section 251(b)(5) to include intrastate access traffic.

Section 251(b)(5) requires all LECs to establish reciprocal compensation arrangements for the transport and termination of telecommunications. Section 252(d)(2) authorizes the state commissions to set reciprocal compensation charges for ILECs,[55] subject to the pricing methodology established by the FCC.[56] The Commission may only establish ILECs' reciprocal compensation rates when a state has refused to act.[57] A central issue here is whether the definition of "telecommunications" subject to Section 251(b)(5) can lawfully be interpreted to include intrastate access traffic historically regulated by state commissions pursuant to Section 152(b) of the Act.

In the 1996 *Local Competition Order*, the Commission interpreted the reciprocal compensation obligations of newly-enacted Section 251(b)(5) as "apply[ing] only to traffic that originates and terminates within a local area," as defined by the state commissions.[58] In the 2001 *ISP Remand Order*, the Commission confirmed this interpretation and explained further that

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54 Chairman's Draft Proposal, at ¶ 190 ("At the end of the transition period, all telecommunications traffic will be treated as falling within the reciprocal compensation provisions of section 251(b)(5), and the states will set default reciprocal compensation rates pursuant to the new methodology we adopt herein.").

55 47 U.S.C. § 252(d)(2).

56 *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 385 (1999).

57 47 U.S.C. § 252(e)(5).

58 *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket Nos. 96-98, 95-185, First Report and Order, 11 FCC Rcd 15499, 16045 (1996) ("*Local Competition Order*"), *aff'd in part and vacated in part sub nom. Iowa Utils. Bd. v. FCC*, 117 F.3d 1068 (8th Cir. 1997) (further history omitted).

Congress intended to exempt certain categories of traffic from Section 251(b)(5).[59] More specifically, the Commission held that the traffic listed in subsection (g)[60] was intended by Congress to be excluded from the reciprocal compensation requirements of Subsection (b)(5). The Commission characterized Section 251(g) as a "carve-out provision"[61] which limits the scope of Section 251(b)(5):

> [W]e focus on the statutory language of section 251(b) as limited by 251(g). We believe this approach is not only consistent with the statute, but that it resolves the concerns expressed by the court in reviewing our previous analysis. Central to our modified analysis is the recognition that *251(g) is properly viewed as a limitation on the scope of section 251(b)(5)* and that ISP-bound traffic falls under one or more of the categories set forth in section 251(g).[62]

The D.C. Circuit's subsequent remand of the *ISP Remand Order* was not based on any disagreement with the Commission's interpretation of Sections 251(b)(5) and 251(g) and the interplay between those subsections, but rather on its conclusion that ISP-bound traffic did not fit within the scope of Section 251(g).[63]

As noted by the Commission in the *ISP Remand Order*, exchange access services provided to interexchange carriers ("IXCs") are specifically enumerated in Section 251(g) and thus were intended by Congress to be exempted from the requirements of Section 251(b)(5).[64]

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59 *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Intercarrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98, 99-68, Declaratory Ruling and Notice of Proposed Rulemaking, 14 FCC Rcd 3689 (1999), *vacated and remanded, Bell Atlantic Tel. Cos. v. FCC*, 206 F.3d 1 (D.C. Cir. 2000); Order on Remand and Report and Order, 16 FCC Rcd 9151, 9165 (2001), *remanded, WorldCom v. FCC,* 288 F.3d 429 (D.C. Cir. 2002), *cert. den.* 538 U.S. 1012 (2003) ("*ISP Remand Order*").

60 47 U.S.C. § 251(g).

61 *ISP Remand Order*, at 9167.

62 *Id.* (emphasis supplied).

63 *WorldCom*, 288 F.3d at 432-33.

64 *ISP Remand Order*, at 9165.

The Commission reasoned that "Congress did not intend to interfere with the Commission's pre-Act authority over 'nondiscriminatory interconnection ... obligations (including receipt of compensation)' with respect to 'exchange access, information access, and exchange services for such access' provided to IXCs or information service providers."[65] In short, "Congress excluded all such access traffic from the purview of section 251(b)(5)" so as not to disrupt pre-existing access regimes.[66]

The pre-existing access regimes preserved by Section 251(g) include both the interstate access charge system administered by the FCC and the intrastate access charge regimes overseen by the state commissions. As acknowledged by the Commission:

> Although section 251(g) does not itself compel this outcome with respect to *intrastate* access regimes (because it expressly preserves only *the Commission's* traditional policies and authority over *interstate* access services), it nevertheless highlights an ambiguity in the scope of "telecommunications" subject to section 251(b)(5) – demonstrating that the term must be construed in light of other provisions in the statute. In this regard, we again conclude that it is reasonable to interpret section 251(b)(5) to exclude traffic subject to parallel intrastate access regulations, because "it would be incongruous to conclude that Congress was concerned about the effects of potential disruption to the interstate access charge system, but had no such concerns about the effects on analogous intrastate mechanisms.[67]

Moreover, as the Commission has noted, although by its express terms Section 251(g) permits the Commission to make an affirmative determination to adopt access charge rules different from those that existed pre-Act, the Commission may only supersede pre-Act requirements for

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65 *Id.*, at 9167 (footnote omitted).

66 *Id.*, at 9168.

67 *Id.* (emphasis in original; footnote omitted).

interstate access services.[68] Section 251(g) "must be construed in light of other provisions in the statute,"[69] including Section 152(b), which reserves to the states exclusive jurisdiction with respect to "charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any carrier ..."[70]

In short, Section 251(g) compels two separate but related conclusions – the conclusion that interstate and intrastate exchange access services cannot be brought within the framework of Section 251(b)(5) and the conclusion that state authority over intrastate access services cannot be overridden by the Commission through application of Section 251(g).

In addition, the context of Section 251(b)(5) is that it applies only between carriers *reciprocally exchanging telecommunications traffic* when at least one of the carriers is a local exchange carrier. Interexchange carriers and local exchange carriers do not exchange traffic in any way recognized by either the Commission or any state commission that would cause an IXC and a LEC to compensate the other reciprocally. In contrast with the arrangements contemplated in Section 251(b)(5), the local exchange carrier has always charged the interexchange carrier for access regardless of the direction of the traffic. There is nothing reciprocal about the access charge regime.

Underscoring the lack of nexus between access charges and Section 251(b)(5) is the statutory pricing standard applicable to Section 251(b)(5) traffic. Section 252(d)(2)(A)(i) of the Act, addressing compliance of incumbent local exchange carriers with Section 251(b)(5), states that the terms of reciprocal compensation are not to be considered just and reasonable unless they provide for the "mutual and reciprocal recovery *by each carrier* of costs associated

68 *Id.* at 9170 ("By its express terms, of course, section 251(g) permits the Commission to supersede pre-Act requirements for interstate access services.").

69 *Id.*, at 9168.

70 47 U.S.C. § 152(b).

with the transport and termination *on each carrier's network facilities* of calls that originate on the network facilities of the other carrier."[71] This language expressly contemplates that compensation under Section 251(b)(5) will stem from a bilateral relationship in which the traffic will originate on one carrier's network and terminate on the other carrier's facilities and that compensation will flow from the originating carrier to the terminating carrier. That type of relationship does *not* exist between an interexchange carrier and a local exchange carrier providing it exchange access services. It is quite clear, and therefore not subject to Commission re-interpretation that Section 251(b)(5) and any Commission jurisdiction that comes with it does not extend to intrastate access charges. Thus, the Commission cannot lawfully adopt an intercarrier compensation plan that treats all traffic – including intrastate access traffic – as subject to the requirements of Section 251(b)(5) of the Act.

IV. THE PRICING METHODOLOGY PROPOSED BY THE CHAIRMAN IS IRRATIONAL AND DOES NOT SATISFY THE REQUIREMENTS OF THE ACT

The Chairman's Draft Proposal rejects the continued use of the TELRIC methodology to set rates for reciprocal compensation traffic under the "additional costs" standard in Section 251(b)(5) in favor of a "new incremental cost methodology."[72] As explained in the Declaration of Lee L. Selwyn, the Chairman's proposed approach "is arbitrary, discriminatory, will result in noncompensatory prices, is biased in favor of the large RBOCs at the expense of CLECs, and at a minimum is certainly not sufficiently developed for adoption in the type of abbreviated time frame being allowed here."[73]

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71 47 U.S.C. § 252(d)(2)(A)(i).

72 Chairman's Draft Proposal, at ¶ 267.

73 Declaration of Lee L. Selwyn, attached to Letter from Brad E. Mutschelknaus, *et al.*, to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Docket No. 05-337, *et al.* (filed Nov. 26, 2008) ("*Selwyn Declaration*"), at ¶ 46.

Dr. Selwyn points out as a threshold matter that the Chairman does not propose that the use of the TELRIC methodology be abandoned for the pricing of UNEs.[74] The TELRIC methodology directs state commissions to use ILEC costs to set the prices ILECs charge other carriers for ILEC services (*i.e.*, UNEs and interconnection arrangements). On the other hand, the incremental costing methodology the Chairman proposes here would rely on ILEC – and mainly BOC – costs to set "prices that CLECs could charge for call termination services they provide to those same BOCs."[75] The BOCs' incentives are to inflate their TELRIC studies in order to justify the highest possible UNE rates their competitors would be compelled to pay.[76] The BOCs' incentives with respect to reciprocal compensation rates are exactly the opposite however. Their goal is to achieve the "*lowest* possible rate level" since they "transfer more traffic to CLECs for termination than occurs in the opposite direction."[77] Consequently, the Chairman's proposal to adopt an incremental cost methodology that excludes several important cost sources from consideration "would produce an outcome that supports the BOCs' goal in a way that is neither reasonable nor consistent with the pro-competition goals of the *Telecommunications Act of 1996* ('*1996 Act*')."[78]

As explained by Dr. Selwyn, the Chairman's Draft Proposal characterizes the "additional costs" methodology it proposes as producing "long run" costs while, "in reality, it is

74 *Selwyn Declaration*, at ¶ 3.

75 *Id.*, at ¶ 4.

76 As explained by Dr. Selwyn, at the time the Commission was developing its TELRIC rules, "it was the RBOCs that had most strenuously objected to a pricing mandate based exclusively upon incremental costs, arguing that it would prevent them from recovering the 'total costs of the network.'" *Id.*, at ¶ 5.

77 *Id.*, at ¶ 4 (emphasis in original).

78 *Id.* (emphasis in original).

far closer to a short-run incremental cost paradigm."[79] This is the case because most costs are treated as fixed and are excluded entirely from the incremental cost calculation.

> [D]espite the FCC's earlier recognition that "the fixed investment costs that, while not variable in the short term, are necessary inputs directly attributable to providing the element," the proposed "additional cost" approach operates to exclude those fixed investment costs altogether.[80]

The Chairman's proposal defines "short run" so narrowly that it "virtually eliminates the possibility of any cost variability."[81] As explained by Dr. Selwyn, the concept of "short run cost" is far more expansive than represented in the Chairman's Draft Proposal. Dr. Selwyn points out that the draft confuses "fixed costs" with the economic concepts of "breakage or of "lumpiness" in supply or demand. The failure to even mention these concepts is "a key omission that may well account for the Chairman's proposed order's apparent misunderstanding of 'short run' vs. 'long run' costs."[82] The Chairman's Draft Proposal also errs in limiting the incremental costs attributable to call termination only to those that can be considered "traffic-sensitive." In other words, the draft considers all non-traffic sensitive costs to be fixed in the long run.[83] That view is "unreasonably static and unrealistic."[84] As Dr. Selwyn notes, "there are numerous cost dimensions even under the 'softswitch' technology that the Chairman's proposed order would require be used as the basis for determining the cost of terminating reciprocal compensation traffic."[85]

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79 *Id.*, at ¶ 8.

80 *Id.* (footnote omitted).

81 *Id.*, at ¶ 10, *quoting* Chairman's Draft Proposal, at ¶ 244.

82 *Id.*, at ¶ 12.

83 Chairman's Draft Proposal, at ¶ 273.

84 *Selwyn Declaration*, at ¶ 16.

85 *Id.*

An additional important shortcoming in the incremental costing methodology proposed by the Chairman is that it excludes all "joint costs" (*i.e.*, costs that are incurred to support two or more separate products or services). The proposed approach includes only those cost elements that are product-specific and that would not be incurred at all if that product were not offered.[86] Dr. Selwyn explains this concept as:

> assum[ing] that the factory here would always be built and that, once built, the capital costs of the factory can be treated as sunk, such that the elimination of one or more products from its output mix would have no *forward-looking* impact upon the (previously committed) investment. Under this distorted notion, the factory is treated as a common or joint cost of all five products, and that as such eliminating any one of them would not affect the capital costs for the factory. Hence, the proposed order seems to conclude, no capital costs can be ascribed to any one specific product and thus must be excluded entirely from the product's "incremental cost."[87]

The "sheer absurdity of this concept"[88] is highlighted by considering the result if the same "incremental cost" methodology were applied to all five products.

> The result of this exercise is that none of the capital costs of the factory would then be ascribed to any of the five constituent products. If the prices of each product were then set on the basis of this "incremental cost," the owner of the factory would have no ability or opportunity to recover its investment, and would certainly have no reason or incentive to make any further capital investments ...[89]

Dr. Selwyn notes that the Chairman seeks to avoid this absurd result by applying the concept of excluding common costs selectively (*i.e.*, to less than all the products jointly produced using the same common plant). Under the Chairman's Draft Proposal, only the termination of inbound

86 Chairman's Draft Proposal, at n. 442.

87 *Selwyn Declaration*, at ¶ 18 (emphasis in original).

88 *Id.*, at ¶ 19.

89 *Id.*

traffic handed off by another carrier would be subject to this "incremental" cost approach. Yet "nowhere in the Chairman's proposed order does the Commission offer any support or basis for this patently discriminatory treatment."[90]

The Chairman's Draft Proposal also errs in treating overhead costs as fixed (and therefore excluded from the "additional costs" calculation),[91] when in fact such costs vary directly and proportionally with direct costs and with the overall scale of an enterprise. Dr. Selwyn notes that nowhere in the Chairman's proposed order does the Commission propose a factual finding to that effect nor does it offer any evidentiary support for its conclusion.[92] This is not surprising in light of the "compelling evidence to the contrary."[93] As detailed by Dr. Selwyn, "[b]oth within individual industries and across multiple industries, 'overhead' costs tend to vary both linearly and roughly proportionately with the overall scale of the business – *i.e.*, with the volume of its output."[94]

Importantly, Dr. Selwyn explains that the Chairman's reliance on the approach put forth by economist Gerald Faulhaber in 1975 to advance its "additional cost" methodology is misplaced and that the "Faulhaber principle" is inapposite to the determination of long-run incremental costs in the current regulatory environment.[95] Faulhaber focused specifically on establishing a cost floor for purposes of identifying the presence of cross-subsidization in an environment in which ILECs were subject to rate-of-return regulation and explicit profit constraints and the activities of the Bell System ILECs were expressly constrained by the 1956

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90 *Id., at* ¶ 20.

91 Chairman's Draft Proposal, at ¶ 266.

92 *Selwyn Declaration*, at ¶ 21.

93 *Id.*

94 *Id.*, at ¶ 22.

95 *Id.*, at ¶¶ 27-36.

Consent Decree. Bell System operating companies did not offer unregulated services and, for the most part, did not face competition for the regulated services they did offer. Bell System and other ILECs were under no obligation to unbundle their networks or to provide UNEs to competitors. None of these conditions – each of which is critical to the Faulhaber theory – are even remotely applicable to the ILECs or CLECs as they exist today.

Finally, Dr. Selwyn notes that while ILECs such as the BOCs are "multiproduct firms producing a mix of services that share an extensive array of common plant and other corporate resources ... individual CLECs may or may not be multiproduct firms ... CLECs are not merely miniature versions of the BOCs."[96] Thus,

> a CLEC's cost structure may bear little resemblance to that of a large ILEC, and a costing methodology such as that being proposed in the Chairman's proposed order that implicitly presupposes comparability as to the incidence of common costs as between ILECs and CLECs will necessarily operate to penalize a CLEC for a decision to specialize in a limited number of services. Such a result would be both patently unfair and grossly anticompetitive.[97]

Dr. Selwyn concludes that "by relying imposing the ILEC's near-zero 'additional traffic-sensitive cost' as the Chairman's proposed order perceives it to be as a basis for the price that CLECs will be permitted to charge, CLECs will be unable to recover their costs and will ultimately be forced out of the market."[98]

96 *Id.,* at ¶¶ 33-34.

97 *Id.,* at ¶ 35.

98 *Id.,* at ¶ 36. Dr. Selwyn notes further that this disadvantage is compounded by the Chairman's Draft Proposal to impose mandatory symmetry on CLEC and ILEC intercarrier compensation rates. *Id.,* at ¶ 37. "The Commission offers no valid justification for imposing BOC costs upon CLECs, and certainly advances no basis for eliminating the ability of a CLEC to demonstrate that its costs are greater than those of the incumbent LEC." *Id.,* at ¶ 38.

Notably, Dr. Selwyn's rejection of what effectively is a short-run incremental cost standard is consistent with the position taken by the RBOCs in the Commission's rulemaking docket considering whether the TELRIC methodology should be modified. As Qwest stated therein, "...setting prices at marginal cost would obviously leave the telecommunications company unable to recover its fixed costs."[99] Similarly, AT&T (then SBC) said that "[f]irms must be able to recover their average costs over the long run or else they will go out of business...A model based on 'short-run marginal cost,' where prices would fall even below TELRIC levels, would be more incoherent still."[100] AT&T (then BellSouth) further explained that because pricing at marginal cost "leaves the shared and common costs of the firm unrecovered...[s]uch pricing is unsustainable, causing firms to exit, and is therefore not efficient in a dynamic sense."[101]

The proposed cost methodology contained in the Chairman's Draft Proposal is ill-considered and poorly supported. There is little, if any, support in the record for abandoning TELRIC as the cost methodology to be employed by state commissions in establishing reciprocal compensation rates. Even if the Commission were inclined to consider modifications to the TELRIC methodology, however, the complete abandonment of a TELRIC approach in favor of the short run incremental cost methodology proposed in the Chairman's Draft Proposal is without foundation. The Commission should reaffirm the use of TELRIC or, at most, invite further comment on whether changes to TELRIC are advisable.

99 Comments of Qwest Communications Corp., CC Docket No. 01-92 (filed Aug. 21, 2001), at 41.

100 Reply Comments of SBC Communications, WC Docket No. 03-173 (filed Jan. 30, 2004), at 14.

101 Reply Comments of BellSouth Corporation, WC Docket No. 03-173 (filed Dec. 16, 2003), at n. 105.

V. IMPLEMENTATION OF COMPREHENSIVE INTERCARRIER COMPENSATION REFORM VIA A GRADUAL TRANSITION IS ESSENTIAL TO AVOID UNDUE ECONOMIC DISRUPTION

As mentioned above, industry analysts have estimated that had the Chairman's Draft Proposal been adopted when and as proposed, the impact on most LECs would have been "swift and negative."[102] Describing the proposed plan as one that would create a "Cash Flow Death Spiral," Raymond James estimated that the average Rural Local Exchange Carrier ("RLEC"), mid-sized LEC, or CLEC would experience a 10% revenue decline and a 38% decline in Free Cash Flow ("FCF"). The result would be "multiple contractions resulting in a significant decline in equity prices." According to Raymond James, ratings agencies would be likely to "downgrade the entire group on concerns that their debt service may be unfeasible, which would have an immediate impact on debt costs and the ability to raise capital and in turn would likely result in lower investment, even lower revenue and lower FCF."[103] While it would be very difficult for the affected companies to absorb such a revenue loss in the best of times, to do so on a flash-cut basis in the current environment is virtually impossible.

To its credit, the Chairman's Draft Proposal recognizes "the need to be cognizant of market disruptions and potential adverse effects on consumers and affected carriers of moving too quickly from the existing intercarrier compensation regimes to [the] new uniform approach to intercarrier compensation."[104] Accordingly, the Chairman's Draft Proposal professes to "adopt a gradual ten-year transition plan with separate stages, designed to reduce rates over a sufficient period of time to minimize market disruptions and to cushion the impact of

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102 "Intercarrier Compensation Reform: Potential Impact from an FCC Order," Raymond James & Associates (Oct. 27, 2008), appended hereto as Attachment A ("*Raymond James Report*").

103 *Id.*, at 1, 3.

104 Chairman's Draft Proposal, at ¶ 190.

… reform on both customers and carriers."[105] Although the stated intention to implement the reforms gradually is commendable, the specific actions proposed do not live up to the verbiage. While the Chairman's Draft Proposal does propose a three-stage, 10-year transition period, the bulk of the access revenue reductions are required during Stage One within 1-2 years. Only one year from adoption, LECs would be required to reduce the gap between their intrastate and interstate switched access rates by 50%; and one year later, they would be required to reduce their intrastate access rates by the remaining 50% to close the gap completely.[106]

In the experience of the Joint Commenters, the loss of intrastate access charge revenues is likely to represent the largest portion of revenue loss to be experienced under the entire reform plan proposed by the Chairman. The proposal to require LECs to absorb these losses within the first two years of the plan renders the suggestion of a 10-year transition effectively meaningless. Simply put, the "hurt" is front loaded, and the 10-year "transition" is anything but "gradual." Consequently, if the Commission elects to preempt intrastate access charge regulation, it is critical that the Commission step down terminating switched access rates more gradually over a longer period of time. Businesses can rewrite business plans, reform contracts, and restructure products to accommodate revenue shifts, but only if the changes are implemented gradually. The Chairman's Draft Proposal falls far short on that score.

While, for the reasons set forth above, the Joint Commenters maintain that the Commission does not have authority to require carriers to reduce their intrastate switched access rates to interstate access rate levels, if the Commission nevertheless decides to do so, the Joint Commenters respectfully request that the Commission afford affected carriers a reasonable

[105] *Id.*

[106] *Id.*, at ¶¶ 192-193.

opportunity to reposition their businesses by revising the implementation schedule. The Joint Commenters suggest that the first reduction occur approximately one year from adoption, but we believe that the proposed two-year 50/50 rate reduction be replaced with a 5-year 20 percent annual reduction schedule. Specifically, we propose a 5-year transition for intrastate switched access charges to be reduced to interstate access levels.

<u>YEAR 1</u>: Jan. 1, 2010 - initial 20% reduction of the difference between intrastate and interstate terminating switched access rates effective Jan. 1, 2009.

<u>YEAR 2</u>: Jan. 1, 2011 - 20% reduction of the difference between intrastate and interstate terminating switched access rates effective Jan. 1, 2009.

<u>YEAR 3</u>: Jan. 1, 2012 - 20% reduction of the difference between intrastate and interstate terminating switched access rates effective Jan. 1, 2009.

<u>YEAR 4:</u> Jan. 1, 2013 - 20% reduction of the difference between intrastate and interstate terminating switched access rates effective Jan. 1, 2009.

<u>YEAR 5</u>: Jan. 1, 2014 - final 20% reduction of the difference between intrastate and interstate terminating switched access rates effective Jan. 1, 2009.

Under this schedule, interstate and intrastate terminating switched access rates would be made uniform over a reasonable period of time – 5 years – but the revenue loss would be absorbed in a more gradual and manageable fashion.

Of course, even under the more business-like transition plan suggested by the Joint Commenters, affected LECs will need to recoup the resulting revenue losses elsewhere in their product mix. As the Chairman's Draft Proposal recognizes, the lion's share of revenue replacement will come in the form of increases to SLCs collected from end users.[107] To be clear, we are not confident that such SLC increases will be sustainable during an economic recession, and are skeptical that end users will be willing or able to replace all of the access revenue lost under the contemplated comprehensive intercarrier compensation reform program. However, it

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107 *Id.*, at ¶¶ 294-302.

is important that the SLC caps be increased in a competitively-neutral manner, thereby giving affected carriers a fair opportunity to recoup their resulting access revenue losses. We are sympathetic, however, to the concern expressed by Free Press that SLC caps should be increased at the same pace that access charges are decreased and, accordingly, the Joint Commenters suggest that federal SLC caps be increased in the same proportion, and on the same schedule, as suggested for the intrastate switched access charge reductions specified above.[108]

VI. ANY REVENUE RECOVERY MECHANISMS ADOPTED BY THE COMMISSION MUST BE COMPETITIVELY NEUTRAL

The Chairman's Draft Proposal would permit price cap and rate-of-return ILECs to offset revenue decreases brought about by overall reductions in intrastate and interstate intercarrier compensation rates with increased federal SLCs and new universal service funding.[109] There are several fundamental problems with this approach towards "lost revenue" that warrant consideration.

A. Any SLC Increases Must Be Applied In A Competitively Neutral Manner

To the extent ILECs are permitted to increase their federal SLCs to recoup intercarrier compensation revenues, the Commission should ensure that such SLC increases are applied in a competitively-neutral fashion. The Commission should not permit ILECs the flexibility to implement SLC increases in an anti-competitive manner by targeting those increases in select areas and for those customer segments for which there is little to no competition.

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108 *See* Letter from Ben Scott, Policy Director, Free Press, to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Docket No. 05-337, *et al.* (filed Oct. 24, 2008) ("*Free Press Proposal*"), at 6-8.

109 Chairman's Draft Proposal, at ¶ 290. The SLC cap for residential and single line business lines would increase from \$6.50 to \$8.00, the non-primary residential line SLC cap would increase from \$7.00 to \$8.50, and the multi-line business SLC cap would increase from \$9.20 to \$11.50. *Id.*, at ¶ 298.

If ILECs are permitted to "load" SLC increases on customers or areas that face less competition and leave SLCs untouched or increased only slightly for customers or areas that face more competition, consumers with fewer choices in less competitive areas will be burdened with unjustified rate increases. At the same time, CLECs – which, by definition, operate in areas where there is greater competition – will experience significant adverse consequences since they will be constrained from increasing their SLCs to customers and in areas where their major competitor (*i.e.*, the ILEC) has refrained from increasing its SLCs. Thus, CLECs will be unable to recoup from their customers lost intercarrier compensation revenues that ILECs can recoup from increased SLCs on their "captive" customers. The Commission can – and should – ensure that this result does not occur by ordering that each ILEC be permitted to increase its SLCs to a particular class of customers only in proportion to the intercarrier compensation revenues previously obtained by the ILEC from that class of customers.

B. Any Universal Service Recovery Mechanism Must Be Competitively Neutral

The Chairman's Draft Proposal also permits ILECs – but not CLECs – to seek universal service funding to replace lost intercarrier compensation revenues.[110] The Chairman's Draft Proposal does not provide for the recovery by CLECs of any lost revenues through the universal service fund. This discrimination violates the U.S. Constitution's equal protection clause. In *Bolling v. Sharpe*, the U.S. Supreme Court held that the Fifth Amendment contains an equal protection guarantee applicable to Congress similar to that found in the Fourteenth Amendment and applicable to the States.[111] Under the test articulated by the Supreme Court,

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110 *Id.*, at ¶¶ 311-316. The Chairman's Draft Proposal treats price cap ILECs and rate-of-return ILECs differently. Price cap ILECs must petition the Commission for USF support, making a showing of need, and the Commission must consider all the company's revenues – both regulated and unregulated – in determining if support is warranted. Rate-of-return ILECs need make no such showing. *Id.*, at ¶ 314.

111 347 U.S. 497, 498 (1954).

"[i]n areas of social and economic policy, a [] classification that neither proceeds along suspect lines nor infringes fundamental constitutional rights must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification."[112] It is clear the universal service recovery provisions of the Chairman's Draft Proposal do not apply to CLECs and other non-ILEC competitors and there is no rational basis for this exclusion.

The most pointed demonstration that there is no rational basis for the exclusion of non-ILECs from the universal service recovery mechanism is that such discrimination would contravene the Commission's own stated objectives in this proceeding. In its *Intercarrier Compensation FNPRM* in this proceeding, the Commission explained that any new intercarrier compensation regime must be "competitively and technologically neutral."[113] In stark contrast to this goal, the Chairman's Draft Proposal would undermine competition by providing a revenue-neutral scheme for ILECs while providing non-neutral treatment for CLECs. Moreover, favoring ILECs at the expense of CLECs does not encourage the efficient use of telecommunications networks or the development of efficient competition, another of the Commission's objectives in this proceeding. The ILECs' legacy hierarchical networks possess certain inefficiencies as compared with CLEC networks and therefore should not be unduly rewarded. But, unfortunately and undeniably, the Chairman's Draft Proposal would do exactly that – it turns the Commission's goals on their head by rewarding the ILECs' inefficient networks and punishing

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112 *See FCC v. Beach Communications, Inc.*, 508 U.S. 307, 313 (1993), *citing Sullivan v. Stroop*, 496 U.S. 478 (1990); *Bowen v. Gilliard*, 483 U.S. 587, 600-603 (1987); *United States Railroad Retirement Bd. v. Fritz*, 449 U.S. 166, 174-179 (1980); *Dandridge v. Williams*, 397 U.S. 471, 484-485 (1970).

113 *Intercarrier Compensation FNPRM*, 20 FCC Rcd 4685, ¶33.

the CLECs' more efficient networks. There is simply no rational basis for this discrimination and it must be rejected.

VII. THE COMMISSION MUST ENSURE THAT ITS INTERCARRIER COMPENSATION REFORM PLAN DOES NOT IMPERMISSIBLY INTRUDE ON STATE AUTHORITY OVER INTERCONNECTION AGREEMENTS

The Chairman's Draft Proposal states that "[w]ith respect to interconnection agreements, we do not disturb the processes established by section 252 of the Act."[114] In the remaining sentences of that paragraph, however, the Draft departs significantly and indefensibly from this sensible conclusion. Indeed, the conclusions reached in the Chairman's Draft Proposal run roughshod over the processes established by Congress in Section 252 in at least three ways, each of which should be rejected by the Commission.

The Chairman's Draft Proposal upends the processes established by Section 252 in its pronouncement that, if adopted, the Chairman's Draft Proposal would constitute a "change in law" – evidently, irrespective of the language contained in particular interconnection agreements.[115] This pronouncement ignores that parties to particular interconnection agreements may have freely negotiated a definition of "change in law" or criteria for triggering change in law amendments that may not be met by the particular order the Commission adopts. This attempt to reform freely negotiated interconnection agreement provisions lies in stark contrast to several provisions in Section 252 that make clear Congress's intent to preserve the ability of parties to negotiate freely. Section 252(a)(1), which allows parties to negotiate "without regard" to Section 251(b) requirements set forth in the Act and adopted by the Commission, is the most notable of these provisions. Section 252(e)(2), which strictly limits the bases upon which a state commission can reject provisions of a negotiated agreement, also stands in contrast to the

114 *Id.*, at ¶ 292.

115 *Id.*

unilateral reformation of interconnection agreements contained in the Chairman's Draft Proposal. Yet, without legal justification, the Chairman's Draft Proposal ignores these statutory provisions and requires the modification of any interconnection agreement under which the Commission's action would not otherwise be considered a change in law event sufficient to require negotiation of an interconnection agreement amendment.[116]

With similar intent and the same unlawful result, the Chairman's Draft Proposal inserts "fresh look" provisions into interconnection agreements where no change in law provisions were negotiated or where "evergreen" status impacts the applicability of change in law provisions.[117] Nothing in Section 252 provides the Commission with the authority to take such action. Rather, doing so runs afoul of the aforementioned Section 252 provisions which preserve parties' ability to negotiate freely and severely restrict the ability of state commissions to reject voluntarily negotiated agreements based on provisions such agreements do or do not contain.

The Chairman's Draft Proposal also upends the processes established by Section 252 by inserting the Commission into a role reserved for the states.[118] Section 252 assigns to the

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116 Ironically, the Chairman's Draft Proposal contains a sentence recognizing that pursuant to section 252(a)(1), carriers remain free to negotiate alternative arrangements. The Draft contains no explanation as to why freely-negotiated change in law provisions are not treated in the same manner and are instead upended in a manner squarely at odds with the statute. *See* Chairman's Draft Proposal, at ¶ 292.

117 It is unclear whether the concern raised by Verizon with respect to agreements in "evergreen" status stems from actual contract language that prevents parties from amending such agreements or from a desire for cover in anticipation of a need to abrogate a unilaterally imposed "no amendment of evergreen agreements" policy. *See* Chairman's Draft Proposal, at ¶ 292 n.763. Either way, the Draft's insertion of the Commission into these instances of interconnection agreement interpretation and implementation is improper and unlawful.

118 *See, e.g.,* Letter from New England Conference of Public Utilities Commissioners, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-92, *et al.*, (filed Oct. 17, 2008), at 14 (asserting that Verizon's Plan and others like it would result in the FCC illegally preempting state jurisdiction over interconnection); Letter from the Delaware Public Service Commission, the Public Service Commission of

state commissions primary responsibility for overseeing the Section 252 interconnection agreement process.[119] As part of that process, state commissions review and approve interconnection agreements and retain jurisdiction to resolve disputes arising thereunder and to approve amendments thereto. The Draft's pronouncement that interconnection agreements are subject to "fresh look" and "change in law" amendments is clearly a pronouncement reserved for the states to make with respect to the interconnection agreements each state commission has approved, if the parties to those agreements are unable to resolve the matter privately. Because it offends rather than adheres to the Section 252 process, the Commission should reject the Draft's proposed intrusion into state commission jurisdiction over Section 252 interconnection agreements.

Finally, the Chairman's Draft Proposal upends the Section 252 processes by providing ILECs with the right to invoke Section 252 negotiations when Congress reserved that right exclusively for a "requesting telecommunications carrier or carriers."[120] The fact that the Commission has done this before says nothing about the legality of the Commission's having done so or proposing to do so again.[121] Section 252 is not a ready-whenever re-negotiation provision that makes the absence of a negotiated change in law provision meaningless or the

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the District of Columbia, the New Jersey Board of Public Utilities, the New York Public Service Commission, and the Pennsylvania Public Utility Commission, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-92, *et al.*, (filed Oct. 27, 2008), at 5-6 (agreeing with New England Commissioners regarding unlawful preemption of state jurisdiction over interconnection).

119 Nearly every provision of Section 252 contains a reference to state commissions and the role they have been assigned in implementing the various statutory provisions. In contrast, the Commission's authority in this context is limited. *See, e.g.,* 47 U.S.C. § 252(e)(6).

120 47 U.S.C. § 252(a)(1).

121 *See* Chairman's Draft Proposal, at ¶ 292 n.762 (citing *Triennial Review Order,* 18 FCC Rcd at 17405, ¶ 703 n.2087). Neither the discussion contained in the *Triennial Review Order* nor any of the statutory provisions cited by the Commission change the fact that Section 252(a)(1) reserves the right to trigger the Section 252 process to requesting carriers other than the incumbent LEC.

provision governing the term of an interconnection agreement expendable. If an ILEC could simply invoke Section 252 to trigger negotiations any time it grew tired of or found inconvenient an interconnection agreement provision,[122] those agreements would become far too malleable and unpredictable to continue to serve the important role they do and would no longer provide a stable and reliable foundation for day-to-day relations between ILECs and their competitors.

In sum, the Chairman's Draft Proposal upends the Section 252 process by (a) reforming voluntarily negotiated interconnection agreements, (b) intruding on state commission authority, and (c) assigning ILECs rights Congress expressly reserved for requesting carriers. For these reasons, the Commission should reject the unlawful conclusions contained therein. A far more sound approach, from both a legal and policy perspective, would be for the Commission to decline to adopt a rule that interconnection agreements must be renegotiated, and to instead leave such issues to the change in law or other relevant provisions in those interconnection agreements, or to voluntary negotiations between the parties to them.[123]

VIII. THE COMMISSION SHOULD NOT DISRUPT EXISTING NETWORK ARRANGEMENTS WHICH ARE INCLUDED IN INTERCONNECTION AGREEMENTS BY ADOPTING NEW INTERCONNECTION RULES

The Joint Commenters and others consistently have opposed attempts by the ILECs to use intercarrier compensation reform as a pretense for the adoption of new network

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122 The Chairman's Draft Proposal fails to explain whether its proposed extension to ILECs of the right to request Section 252 interconnection agreement negotiations is: (a) limited to instances where ILEC-friendly changes in law are adopted by the Commission and the ILEC seeks to avail itself of those changes in law despite having agreed to interconnection agreement provisions that insulate the parties from such changes for an agreed-upon period of time; (b) limited in some other manner; or (c) unlimited. Regardless, the legal foundation for the proposal is utterly lacking, as Congress's grant of the right to request Section 252 interconnection agreement negotiations (quite sensibly) was not a grant made to the ILECs.

123 The Chairman's Draft Proposal reaches this conclusion with respect to so-called "commercial" agreements without making any attempt to provide legal justification or explanation for the conflicting conclusions. There is no reason why negotiated provisions in one context should be treated differently than in the other.

interconnection rules.[124] Accordingly, the Joint Commenters oppose the "default rules regarding the network "edge" contained in the Chairman's Draft Proposal.

Although the meaning and impact of the so-called default rules regarding the "network edge" is far from clear, it is clear that the Chairman's Draft Proposal provides no legal or policy justification for such rules. In lieu of such analysis, the Draft simply recites AT&T's and Verizon's explanations of what the network edge rules do not do.[125] These explanations that the default edge rules (a) "would not require changes to physical points of interconnection,"[126] (b) do "not alter any of the obligations of incumbent LECs to interconnect at any technically feasible point,"[127] and (c) do "not alter carriers' ability to request interconnection,"[128] are no substitute for a reasoned legal and policy justification and analysis explaining what the new rules actually do and why they are necessary.

Moreover, the assertions regarding what the default edge rules do are dubious. By defining which party has financial responsibility for delivering traffic to the network edge, the Chairman's Draft Proposal, despite its assertions to the contrary, is in reality upending network interconnection arrangements by shifting financial responsibility from ILECs to CLECs who, under the new default rules, would be required to pay to transport traffic beyond an established point of interconnection all the way to the network's (inner) edge. The existing network interconnection arrangements which effectively would be displaced by the Chairman's

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124 *See e.g.,* Reply Comments of Broadview Networks, *et al.*, CC Docket No. 01-92 (filed Feb. 1, 2006), at 16-20; *see also, e.g.,* Letter from Genevieve Morelli, Counsel to Broadview Networks *et al.*, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-92, *et al.* (filed Oct. 27, 2008), Attachment at 1, ¶ 3.

125 *See* Chairman's Draft Proposal, at ¶ 275.

126 *Id.*

127 *Id.*

128 *Id.,* at n.726.

Draft Proposal are based on the Commission's longstanding interconnection rules, state commission arbitrations implementing those rules, and voluntarily agreed-upon arrangements contained in interconnection agreements. The Chairman's Draft Proposal contains no explanation why those efforts need to be reconsidered and potentially overridden in conjunction with the end of a transition period to a uniform intercarrier termination rate. Indeed, the fact that the Chairman's Draft Proposal refrains from implementing the default edge rules until the end of the 10-year transition period shows that they are unnecessary.[129]

Moreover, importantly, the Commission would be ill-advised to set such specific network interconnection rules today based on network configurations and architecture currently deployed and that easily could become obsolete in 10 years (if not sooner). This point underscores a fundamental disconnect in the Chairman's Draft Proposal. That disconnect is the desire to base intercarrier compensation rates on a hypothetical network of the future while defining corresponding transport and interconnection obligations based on legacy ILEC network topography (which may no longer be in place ten years from now). The more reasoned approach is for the Commission to refrain from addressing network architecture rules and, for that matter, any other rule changes which are not integral to the goal of intercarrier compensation reform.

IX. THE PROPOSED HYBRID CONTRIBUTION REFORM MECHANISM IS UNNECESSARILY COMPLEX

The proposed orders claim that universal service contribution reform is necessary because revenues have declined[130] and the classification of revenues has become increasingly difficult due to bundled service packages.[131] According to the proposed orders, a hybrid USF mechanism would serve the public interest by: (a) "simplifying" and "stabilizing" the basis for

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129 *Id.*

130 Chairman's Draft Proposal, at ¶ 94; Chairman's Alternative Proposal, at ¶ 90.

131 Chairman's Draft Proposal, at ¶ 95; Chairman's Alternative Proposal, at ¶ 91.

assessments;[132] (b) being "easier to administer, facilitating greater regulatory compliance";[133] (c) being "readily applicable to emerging service offerings";[134] (d) creating incentives for providers to use numbering resources inefficiently; and (e) minimizing the potential for providers to engage in "bypass activities."[135] Unfortunately, the hybrid mechanisms contained in the Chairman's draft proposals would achieve none of these goals.

A. The Proposed Hybrid Methodologies Would Be Complex And Harder To Administer Than A Pure Revenues Or Connections Based Methodology

The hybrid USF contribution methodologies described in the proposed orders are not simple, and they would not be easy to implement or administer. As an initial matter, hybrid methodologies are inherently more complex than pure revenues or connections-based methodologies because service providers must implement, administer, and comply with two separate methodologies and set of systems rather than one. With respect to the proposed hybrid methodologies, service providers would suffer the detriments associated with each component of the hybrid methodology without enjoying any offsetting benefit because the individual components of each proposal share no common elements that could facilitate efficiencies. Moreover, the individual components of the proposed hybrid methodologies are also fundamentally inconsistent with each other, which means that a hybrid contribution mechanism would introduce additional complexity and ambiguity into the universal service program.[136]

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132 Chairman's Draft Proposal, at ¶ 107; Chairman's Alternative Proposal, at ¶ 103.

133 Chairman's Draft Proposal, at ¶ 110; Chairman's Alternative Proposal, at ¶ 106.

134 *Id.*

135 *Id.*

136 For example, many carriers purchase telecommunications services (which are not associated with telephone numbers) from third-party carriers for use in providing various types of telecommunications and information services (some of which are associated with telephone numbers and some of which are not) to their end users. Moreover, many carriers offer bundled packages of services that use telephone numbers with services that do not use telephone numbers. Under these circumstances, the attribution rules would be

Limits in the Commission's authority make the numbers-based components of the proposed hybrid methodologies particularly complicated and difficult to administer. The proposed orders claim that the Commission's authority to adopt the numbers-based portion of the hybrid scheme derives from Section 254(d), Title I, and Section 251(e). However, the proposed orders merely list potential sources of authority without applying the relevant tests necessary to exercise that authority, and the proposed orders themselves implicitly recognize that there are limits to the reach of the Commission's authority.[137] Unfortunately, the manner in which the proposed orders attempt to address the limits on Commission authority merely increases the ambiguity and complexity of the proposals, as explained in more detail below.

1. Limits On The Commission's Permissive Authority Under Section 254(d) Create Complexity And Ambiguity

Under the Act, the Commission has the authority to require contributions from providers of "interstate telecommunications services."[138] The Commission may also require "[a]ny other provider of interstate telecommunications" to contribute to universal service, but only to the extent that the "public interest ***so requires***."[139] Before the Commission can require contributions from these "other providers of interstate telecommunications," however, the agency must make a three-part finding that: (a) the "provider furnishes or supplies components of a service"; (b) the provider provides "telecommunications" that are interstate in nature; and (c)

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unnecessarily complex since the manner for calculating contributions vary greatly between different for services that use telephone numbers and services that do not.

137 *See, e.g.,* Chairman's Draft Proposal, at ¶ 103; Chairman's Alternative Proposal, at ¶ 99.

138 47 U.S.C. § 254(d).

139 *Id.* (emphasis added); *Universal Service Contribution Methodology*, 21 FCC Rcd 7518, 7538 (2006) ("*Interconnected VoIP USF Order*").

the public interest **requires** contributions by these providers to the federal universal service fund.[140]

The proposed orders recognize that not every provider which would be subject to the mandatory contribution requirement is a "telecommunications carrier."[141] The proposed orders claim "[nonetheless that] we have authority to require them to contribute." In support of this claim, the proposed orders state merely that "all of these providers provide – directly or indirectly – some amount of interconnection to the public switched telephone network (PSTN)," which benefits consumers;[142] and "it is in the public interest . . . . that these providers contribute."[143]

The proposed orders do not even attempt to identify the types of services provided by the entities that will be subject to the new contribution methodology, let alone analyze whether the provider furnishes or supplies components of a service that includes "telecommunications" that are interstate in nature.[144] Without undertaking this analysis, it is impossible to determine whether "the public interest requires contributions by these providers to the federal universal service fund" as required by Section 254(d).[145] Simply stating that every user of a telephone number enjoys the capability of interconnection to the PSTN to their benefit is insufficient to satisfy the statutory standard for permissive authority under Section 254(d). The Commission can make the required findings only on a service-by-service or application-by-application basis.

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140 *Id.*, at 7538-40.

141 Chairman's Draft Proposal, at ¶ 103; Chairman's Alternative Proposal, at ¶ 99.

142 *Id.*

143 *Id.*

144 *2006 Interim Contribution Methodology Order*, 21 FCC Rcd at 7538-41, ¶¶ 38-45.

145 *Id.*

The proposed orders recognize the limits on the Commission's permissive authority under Section 254(d), but the manner in which the orders address those limits would impermissibly shift the burdens and complexity to service providers. Specifically, the Chairman's Alternative Proposal states as follows:

> We recognize that, in some situations, the entity with the direct relationship with the ultimate end user may not be an entity over which the Commission has exercised its mandatory or permissive authority under section 254(d). In such situations, we will treat that entity as the end user and its underlying carrier or telecommunications provider as the contributor. This approach ensures that each Assessable Number will be assessed its appropriate universal service contribution, while also ensuring that the Commission does not exceed its authority under section 254(d).[146]

The admission that the Commission does not have permissive authority pursuant to Section 254(d) merely due to use of a number by a service provider flatly contradicts the claim that the Commission has permissive authority to require contributions from every provider using a number because they all "provide – directly or indirectly – some amount of interconnection to the public switched telephone network (PSTN)."[147] Moreover, as a result of these contradictory statements, the Commission has failed to provide any guidance whatsoever about which entities are subject to the mandatory contribution requirement, which necessarily will lead to disputes among service providers.

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146 Chairman's Alternative Proposal, at ¶ 65 (footnotes omitted).

147 Chairman's Draft Proposal, at ¶ 103; Narrow USF Reform Proposal, at ¶ 99.

2. The Commission's Ancillary Authority Under Title I Does Not Cure The Limits Of Its Permissive Authority Under Section 254(d)

Title I is cited in the proposed orders, but the orders do not explain how Title I authorizes the Commission to adopt the numbers-based component of the hybrid scheme.[148] The proposed orders do not even suggest that Title I could extend the Commission's permissive authority under Section 254(d). Of course, ancillary jurisdiction cannot be used to expand the Commission's authority into areas where the Commission's authority is otherwise limited, lest the jurisdictional limitations in the Act cease to have any meaning.[149] Indeed, the proposed orders exclude purely intrastate numbers from the contribution requirements in recognition of the limits on the Commission's authority.[150] Unfortunately, by defining "Assessable Numbers" to exclude numbers used for solely intrastate services, the proposed orders would force retail

148 Moreover, the claim in the proposed orders that every number involves "interstate . . . communication by wire or radio" and thus the FCC has sufficient authority under Title I is false, as the FCC itself recognizes later in the proposed order. Chairman's Draft Proposal, at ¶ 105; Chairman's Alternative Proposal, at ¶ 52.

149 *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 381 n.8 (1999) ("The Commission could not, for example, regulate any aspect of intrastate communication not governed by the 1996 Act on the theory that it had an ancillary effect on matters within the Commission's primary jurisdiction.").

150 Chairman's Draft Proposal, at ¶¶ 104,116; Narrow USF Reform Proposal, at ¶¶ 51, 63; Chairman's Alternative Proposal, at ¶¶ 100, 112. With respect to numbers associated with services that are both interstate and intrastate in nature, proposals to impose a contribution requirement that do not track the interstate and intrastate mix of services associated with that number arguably violate Section 152(b) because such an assessment would invariably affect intrastate service providers decisions on whether and how to provide intrastate services. *See* Letter from Todd Daubert, Counsel to Broadview Networks, Inc, *et al.*, to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Docket No. 05-337, *et al.* (filed Oct. 24, 2008), at 5;. Comments of Verizon Wireless, CC Docket Nos. 90-571, 92-237, 95-116, 96-45, 98-170, 98-171, 99-200, NSD File No. L-00-72 (filed Apr. 22, 2002), at 7-8 (arguing that "any flat rate would represent an impermissible assessment on intrastate revenues" because the proposed mechanism "would improperly assess contributions on all ... phone connections, whether or not they generate interstate revenue."); *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 447-48 (5th Cir. 1999).

service providers to track the jurisdictional nature of numbers, which would also lead to disputes between wholesale service providers and their customers.[151]

The Commission similarly lacks authority to impose contribution requirements upon international traffic, although none of the proposed orders addressed the issue of international-only services. In the *First Report & Order*, the Commission found that carriers that provide only international telecommunications services are not "telecommunications carriers that provide interstate telecommunications services," and, therefore, are exempt from mandatory universal service contribution obligations.[152] One example of such services is international "call-back" services.[153] These services make use of U.S. telephone numbers, but provide purely international services when used to connect calls between end-users not located in the United States.[154] As such, the Commission would have to define Assessable Numbers to exclude numbers used for solely international services, which would result in the same complexities and burdens created by the exclusion of numbers used solely for intrastate services.[155]

151 Chairman's Draft Proposal, at ¶ 116; Chairman's Alternative Proposal, at ¶ 63.

152 *Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776, ¶ 779 (1997).

153 *See, e.g., Enforcement of Other Nations' Prohibitions Against the Uncompleted Call Signaling Configuration of International Call-Back Service,* Order, 18 FCC Rcd 6077 (2003) (declining to enforce foreign restrictions on international call-back services).

154 *Id.* Accordingly, these services lack the interstate element necessary to allow the Commission to include them in assessing universal service contributions.

155 At a minimum, carriers would have to track the jurisdictional nature of services associated with specific numbers, and exclude numbers associated with intrastate services from the contribution requirement altogether, which represents a significant burden for contributors. That numbers can be ported and redirected to services with significantly different jurisdictional characteristics, or even used for services whose jurisdictional characteristics vary significantly over time, compounds this burden.

3. Section 251(e) Does Not Provide The Commission With Authority To Impose Universal Service Contribution Requirements

As with Title I, the proposed orders cite Section 251(e) as a source of authority but fail to explain how Section 251(e) authorizes the Commission to adopt the numbers-based component of the hybrid scheme.[156] The Commission's authority under Section 251(e) over numbering administration is irrelevant in this context. Section 251(e)(1) grants the Commission "exclusive jurisdiction over those portions of the North American Numbering Plan that pertain to the United States." Section 251(e)(2) requires that the "cost of establishing telecommunications numbering administration arrangements and number portability … be borne by all telecommunications carriers on a competitively neutral basis." However, nothing in Section 251 expands, supplements or modifies Section 254, which explicitly sets forth the limits of the Commission's authority to require contributions to the universal service fund.[157]

B. The Complexity Of The Proposed Hybrid Mechanism Would Negate Any Benefits Of Reform

The hybrid contribution methodologies described in the proposed orders are very complex, and they would not be easy to implement or administer. In fact, the hybrid contribution methodologies described in the proposed orders would be more complex than the current revenues-based methodology due to the numerous distinctions they would add to the contribution methodology. For example, the proposed hybrid contribution methodologies would create the following distinctions:

Residential/Wireless v. Business: The application of different methodologies to residential/wireless services and business services is unnecessary. Not only would the distinction force service providers to track accounts by customer type, which would not always be apparent in the case of small businesses, it would create incentives for arbitrage depending upon which service type pays lower contributions. This is particularly true since accounts that

156 Chairman's Draft Proposal, at ¶ 102; Chairman's Alternative Proposal, at ¶ 49.

157 47 U.S.C. § 251(e).

appear to be residential may actually be used for business purposes, and many businesses have wireless accounts.

Entities Covered by Section 254 v. Entities Not Covered by Section 254: By creating a distinction between entities based upon whether "the Commission has exercised its mandatory or permissive authority under section 254(d)" over them,[158] the Commission has forced service providers to make complex decisions about the jurisdictional status of themselves and their customers, which is further complicated by the fact that the Commission's statements regarding the types of entities subject to Section 254(d) are far from clear. Moreover, service providers must also track numbers by this distinction.

NANP Numbers v. NANP Number Equivalents: By defining Assessable Numbers to include "alternative methods" to bypass NANP-issued numbers to the extent they "are the functional equivalent of numbers and otherwise meet our definition of Assessable Numbers," [159] the Commission has hopelessly complicated the contribution methodology. If the Commission cannot articulate the specific methods covered by its order, it cannot reasonably expect service providers to do. This attempt at a "catch-all" definition is impermissibly vague, which infinitely increases the opportunities for bypass, the burdens of compliance and the difficulties associated with enforcement. This is particularly true since the facts necessary to make this determination likely will not be known by the service provider.[160]

Number (or Number-Equivalent)-Based Service v. Non-Number Based Service: By making a distinction between number (or number-equivalent)-based service and non-number based services, the Commission has created yet another category that service providers will have to track.

Each of these distinctions increases the complexity and ambiguity associated with the hybrid methodologies described in the proposed orders.

Complexity and ambiguity increase the burdens of compliance, create additional opportunities for arbitrage, and make compliance audits much more difficult, all of which ultimately make this proposed contribution mechanism less stable and predictable. Instability harms end users, particularly residential end users who are less likely to be able to take steps to reduce their universal service contribution obligation and who face greater harm from

158 Narrow USF Reform Proposal, at ¶ 65.

159 Chairman's Draft Proposal, at ¶ 129; Narrow USF Reform Proposal, at ¶ 77; Chairman's Alternative Proposal, at ¶ 125.

160 By not including "alternative methods," the numbers-based methodology would be easy to arbitrage, which highlights the fundamental flaws in the hybrid methodology.

unexpected increases in contribution levels. These complexities, which exceed those associated with the current revenues-based methodology, would negate any benefits of contribution reform. Moreover, the Commission has no basis or record support for its claim that the administrative costs of implementing the reforms would be minor or that these costs would be outweighed by the benefits.[161] Indeed, the opposite is true.

C. The Proposed Distinction Between Residential/Wireless Services And Business Services Would Be Unreasonable And Inequitable

Applying an entirely different contribution methodology to residential/wireless services and businesses services is unnecessary, and the resulting distinctions between contribution rates would be inequitable. Not only would the distinction increase the complexity and ambiguity of the contribution methodology, as described above, but the flat rate for business connections would result both in over- and under-contributions to the universal service fund in comparison to the numbers-based scheme that applies to residential and wireless services. For example, businesses that use low quantities of numbers and/or high quantities of connections may be forced to over-contribute in comparison to residential and wireless end users. By contrast, businesses that use high quantities of numbers and relatively low quantities of connections may under-contribute in comparison to residential and wireless end users. The proposed orders are silent with respect to why application of radically different contribution methodologies to these different classes of customers would be appropriate, which is particularly important since businesses use wireless services and small business usage can resemble residential usage in some respects.

161 Chairman's Draft Proposal, at ¶ 127; Chairman's Alternative Proposal, at ¶ 75.

X. CONCLUSION

For all of the foregoing reasons, the Commission should adopt intercarrier compensation and universal service reforms that are consistent with the proposals contained herein.

Sincerely,

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ATTACHMENT A

Telecommunications Services
Wireline
Industry Brief

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Intercarrier Compensation Reform: Potential Impact From an FCC Order

- The Federal Communications Commission (FCC) is currently considering a proposal to reform intercarrier compensation in almost all of its forms. The Commission faces a November 5th deadline by the courts to respond to a Voice over Internet Protocol (VoIP) ruling and is attempting to deal with all these issues at one time.
- When it is all said and done, we believe this order will not have the support needed at the commission to pass. But the likelihood in the current political environment is much higher than we have seen in the past, so we believe it is prudent to explore the potential impact.
- The net effect of the order appears to be a decline in access-based revenue, without a replacement mechanism that would have a materially negative impact on free cash flow (FCF) and capital availability. We estimate the average company in the group impacted by the ruling would experience a 10% revenue decline and a 38% decline in FCF. We would also expect multiple contraction and skepticism towards investing in the group by debt and equity investors for some time should the order pass.
- The order is almost certain to be appealed by the courts, and we estimate at least 3 years before any resolution would be met and then an estimated 10-year phase-in of the program. Realistically, this would have a tremendous backlash from the states, in our opinion, which would claim the FCC lacks legal ground to preempt their statutory authority to regulate intrastate rates. Next, the carriers, Congress, and consumer advocates are all likely to weigh in with suits of their own, making this order is very unlikely to ever come to fruition. However, in the current environment, the impact to investors could be very negative; thus, we are outlining the impacts as we see them in this report.

The Order as it is Rumored To Be. Attempting to comply with a court ordered November 5th deadline for Intercarrier compensation reform, FCC Chairman Martin has reportedly issued a report and order, order on remand, and further notice of proposed rulemaking on the topic, also incorporating changes to the Universal Service Fund (USF). The proposal, which has not been released publically, would call for the unification of interstate and intrastate rates to a state-structured reciprocal compensation regime. Carriers would be permitted to make up some of the shortfall with a $1.50 increase on residential subscriber line charges (SLCs) and $5 increase on business lines. The order also goes further, requiring broadband build-out commitments in rural areas to continue to get USF money, which would include wireless eligible telecommunication carriers (ETCs) as well, while removing the identical support rule and require these wireless ETCs to justify their costs. The order also has provisions to deal with "phantom traffic" and requiring labeling and other protections to ensure arbitrage is eliminated. Lastly, the order attempts to adjust the collection mechanism for USF to be based on phone numbers rather than long distance and international calling revenue. In one fell swoop, the FCC appears to be taking all of the areas of controversy within the industry and wipe them out, but we do not believe it will be that simple. The real issue here is the apparent lack of financial modeling that has been done in conjunction with an order that has significant economic and public policy implications.

The biggest issue that investors should be focused on is the unification of access rates as it could have a materially negative impact on the revenue and FCF of most of the public rural Incumbent Local Exchange Carriers (ILECs) that we have in our coverage universe. Access is and always has been a bigger subsidy driver for these carriers than USF, but as it is generally less well understood, its application varies widely by state. The FCC (according to the many reports we have read on the subject) appears to be looking to unify both interstate rates (currently $0.055 per minute) and intra-state rates which vary from the interstate rate to well over $0.10 per minute in some cases. These access charges that are used to compensate carriers for calls that originate and terminate on their network serve a dual purpose in that the rates (particularly the widely varying intra-state rates) help pay for the wear and tear on the network of calls originating from other carriers. The secondary reason for these rates is to support the public policy goal of supporting the cost of providing service to customers that otherwise it would not be economical to service.

This is the concept of "rate balancing" where state Public Utility Commissions (PUCs) would examine overall network traffic volume and adjust per-minute access rates so the carrier would be able to, on average, make a profit and for investors to earn an acceptable return. This way, some customers are still extremely profitable while others are very unprofitable, but on average, the access fills in the gaps and it works out. The trade off is that the public policy of affordable and highly reliable phone service to all Americans is realized. This has given rural schools, hospitals, governments, and citizens (sometimes known as voters) high quality phone service with reasonable basic local rates. The access charges are then passed onto the customers by the long distance provider (via per-minute rates or bundled pricing) for each minute of long distance calls made based on the rate for the originating and terminating access to the carriers on each end of the call.

Competition and the evolving nature of long distance voice calling, the Internet, email, and other means of communication including wireless have altered this "balanced" access mechanism considerably. Over time, we do agree that this implicit support needs to be moved to a more explicit support (we have always advocated a state universal service fund in each state to replace the intra-state access). However, the idea that the access can be lowered at least 90% overnight and only be replaced with a $1.50 increase in the residential SLC and a $5 increase in the business SLC does not hold water.

In the table below, we very conservatively demonstrate that the rural ILECs in our coverage universe would stand to lose about $1.05 billion in revenue from switched access per line net of an average $2.38 increase in the SLC (using a weighted average of a higher SLC increase for business lines). We also point out this is a static analysis, assuming no additional customers leave as a result of the higher SLC, which is highly likely (particularly for business customers in more competitive areas) and would make the total impact even worse.

All Carriers End of Q2	
Total Lines	15,635,085
Revenue	$16.682 billion
10% Access Assumption	$1.668 billion
90% Minimum Decline	$1.501 billion
Minimum Decline per line	$96
Decline per month	$8.00
Net decline after $2.38 SLC Increase	$5.62
Annual Loss	$1.054 billion

Source: Company reports and Raymond James Estimates

Take the other 900 ILECs and other carriers, and the number is substantially higher than the FCC chairman's $500 million estimate he has said publicly. Additionally, the customer would then see the price of their local bill go up, inciting backlash for the rate increase they do not understand and possibly pushing customers away to voice over Internet Protocol (VoIP) or wireless. This only further increases the cost pressure on the carrier and jeopardizing the service for the vast majority of the carriers customers that do not choose to move to another platform. One other thing to point out, the total access exposure varies widely from less than 1% of revenue to close to mid-teens percentage, and the net FCF impact averages 38% but is over 80% to some carriers, making dividend cuts a reality. Lastly, this risk is particularly acute for the 20% to 30% of estimated customers where there are no real viable competitive alternatives to the local service provider, and clearly no replacement for a similar broadband provider.

The Cash Flow Death Spiral. We believe the impact to the group from such a move by the FCC would be swift and negative. We estimate that this sort of drop in revenue (not even factoring in potential additional line losses and wireless substitution, capex to support broadband mandates, etc.) would flow directly through to EBITDA and FCF, making valuation assumptions change accordingly. Next would be multiple contraction resulting in a very significant decline in equity prices. In the current environment, the ratings agencies cannot afford to be late to another troubled sector and are likely to downgrade the entire group on concerns that debt service may be unfeasible, which would have an immediate impact on debt costs and the ability to raise capital and in turn would likely result in lower investment, even lower revenue, and lower FCF. We would expect this to put significant pressure on the group. Given the severity of the potential action, we can only assume the FCC has done extensive financial modeling on this although we have mixed reports on the knowledge of the financial impact from all parties involved.

This, of course, would be an extreme outcome, but a logical conclusion of the draft order as we understand it to be written currently. We would encourage investors to look at these names carefully and call for additional time to work out a reasonable solution that can serve all the public policy needs, keep telecom voice and data services affordable and (more importantly) available for all Americans, and protect the ability to earn a reasonable rate of return on their investment.

What is Likely To Happen. Clearly one likely scenario is that the Chairman lacks the votes necessary to push this through and has to settle for a short answer to the court imposed deadline on VoIP traffic it currently faces. This is increasingly likely, in our opinion, given the pressure and information that is being lobbed at the FCC and Capitol Hill currently. If the order is passed, there will immediately be a large number of lawsuits filed to have the order stayed pending court appeal. Everyone from the companies themselves to state utility commissions to consumer advocates will likely want to see this one blocked or at least thought out in a more deliberate and equitable fashion.

We estimate a court appeals process could take 3 years to go through all of its iterations. Then, the 10-year phase-in period we understand is currently being discussed would begin, so it could be at least 4 years before any real negative cash flow implications of this order are actually felt be the carriers. The problem is we do not believe investors will have the patience to wait this out and would expect a Wall Street-style, worst- case scenario trading and valuation range to be imposed until clarity is given at least 3 years out. So, while the order will mean nothing in the near term and at least through 2 rounds of appeals and re-writing (if it ever means anything at all), the impact could be very negative.

Does Anyone Win? Yes, the regional Bell operating companies (RBOCs) should come out way ahead on this, even though the USF side is likely to be a bit of a drain on AT&T and Verizon. The access revenue they will pocket without any requirements to give it back will be very significant, and this is the reason we have heard all of the RBOCs being very silent in this fight so far. This is also one of the main reasons we hear the competitive local exchange carriers (CLECs) arguing against this as they see the RBOCs getting ahead while they, potentially, do not. The real question for the CLECs is: "What cost savings they would enjoy and would that make them net beneficiaries, too?" We believe it might, but this is really an immaterial event for them, in our opinion, as we have not been able to gather any actual numbers.

Who Really Losses? We believe the mid-sized price cap carriers (CTL, FTR, WIN, IWA, CNSL, and FRP) have the most to lose and stand to have an "unfunded obligation." This means they have regulatory-imposed obligations be the carrier of last resort (COLR) in their service territory but will not be able to service those obligations without losing money. Our recent meetings in Washington indicate this is a point of sympathy that may help the carriers avoid the issues they face. One major aspect of our analysis is the conservative application of the $2.38 weighted average SLC increase across all access lines. We would argue that the access changes impact all lines relatively impartially, but the competitive dynamics in a significant percentage of rural markets may make a $5 SLC increase (or higher) for a local small business and a very visible $1.50 SLC increase on residential customers untenable, exacerbating the impact of lost access revenue. Other price increases would face state PUC scrutiny as well.

We see Embarq as being the least impacted by these changes. We estimate Embarq's FCF impact would be about 18%, taking their payout to about 47% of our 2009 FCF estimate. The real question here would be whether or not the rating agencies would cut Embarq below investment grade, which would increase their cost of debt and further pressure FCF. This is clearly a possibility, and given that the true stripes of the rating agencies have come to light again, we would expect them to react quickly with industry wide downgrades. Iowa Telecom appears to have the most to lose with a potential reduction of over 53% of its FCF, which would necessitate a dividend cut, in our opinion, given our 2009 payout ratio estimate of 74%.

Incumbent Local Exchange Carriers (ILECs)

Company Name	Ticker Symbol	(in $thousands) Revenue 2008E	Revenue 2009E	EBITDA 2008E	EBITDA 2009E	Levered FCF Per Share(1) 2008E	Levered FCF Per Share(1) 2009E	Net Access Lost ($m)	As a % Revenue	As a %FCF
Cincinnati Bell (MO2)	CBB	1,416	1,468	484	508	0.62	0.71	13.1	0.9%	8.6%
CenturyTel, Inc. (MO2)	CTL	2,603	2,581	1,258	1,223	5.20	5.25	230.0	8.8%	26.6%
Frontier Communications (MO2)	FTR	2,266	2,258	1,240	1,237	1.45	1.45	216.1	9.5%	29.0%
Consolidated (MO2)	CNSL	423	421	181	183	2.19	2.46	22.5	5.3%	29.6%
Embarq (SB1)	EQ	6,209	6,004	2,659	2,622	6.31	7.07	278.0	8.1%	18.3%
Iowa Telecom (MP3)	IWA	245	254	129	131	2.06	2.20	35.4	14.4%	53.5%
Windstream (MO2)	WIN	3,231	3,263	1,678	1,686	1.67	1.70	259.8	8.0%	26.5%
Fairpoint	*FRP*	*1,454*	*1,440*	*560*	*555*	*1.53*	*1.76*	207.5	14.3%	82%
								Mean	9.8%	37.9%
								Median	8.8%	29.0%

Source: Company reports and RJ estimates, mean and median exclude CBB. FRP is not covered by Raymond James.

Who Is Not Impacted? We believe that **Alaska**, **Otelco**, and **Cincinnati Bell** would be the least impacted carriers if Martin's proposal were to be passed by the FCC. We believe Alaska would be spared on two fronts, first because its rate of return status would allow for cost recovery and second because there is rumored to be an exemption for Alaska and Hawaii. Otelco should also see little to no impact because it is rate of return and would have access to cost recovery mechanisms to compensate for lost access revenue. Cincinnati Bell should be spared because it has a small percentage of access revenue in relation to its overall more diversified revenue stream. If Cincinnati Bell were successful in implementing SLC increases combined with potential cost savings from terminating access costs outside of its region, it could make the company a net beneficiary of the ruling. Thus we believe it should be a non-issue.

The Policy, The Process, and the Reformers. This is a typical Washington political situation in our opinion. It is hard to explain the sudden urgency of the commission to move on a highly complex set of issues after 10 years, giving only 2 weeks and throwing out other programs that at least had some semblance of agreement within the industry and the states. Such a move appears irresponsible to us given the potential financial impact and the current market conditions, but this may just be its undoing. Our visits to Washington over the past 2 weeks where we have spoken with Senate, House, and FCC representatives about this tells us there is as much uproar about "the process" as anything else.

As we said earlier in this report, we believe this is not likely to pass, particularly given the significant amount of pushback that it is getting in spite of the process was apparently crafted to avoid such scrutiny late in a heated election. However, this does appear to have a much more reasonable chance of passing than any other fringe reform that we have heard rumors of over the last nine years, so we are giving it its due attention. We believe investors should think through the implications of the order prior to November 4th, particularly in this current environment.

Frank Louthan - 404-442-5867

Wireline Telecommunication Services

Comparable Company Analysis (in millions, except per share)

Company Name	Rating	Ticker Symbol	10/26/08 Price	Market Cap.	Enterprise Value	Revenue 2008E	Revenue 2009E	EBITDA 2008E	EBITDA 2009E	EPS 2008E	EPS 2009E	Levered FCF Per Share(1) 2008E	Levered FCF Per Share(1) 2009E	P/E Multiples: 2008E	P/E Multiples: 2009E	Levered FCF Multiples: 2008E	Levered FCF Multiples: 2009E	Dividend Yield	Enterprise Value Multiples: Revenue 2008E	Enterprise Value Multiples: Revenue 2009E	Enterprise Value Multiples: EBITDA 2008E	Enterprise Value Multiples: EBITDA 2009E
Incumbent Local Exchange Carriers (ILECs)																						
AT&T Corp.	2	T	$24.68	146,130	221,310	124,529	129,773	43,876	43,825	2.86	2.97	1.42	2.38	8.6x	8.3x	17.4x	10.4x	5.4%	1.8x	1.7x	5.0x	5.0x
Qwest	4	Q	$2.29	4,012	17,478	13,320	12,620	4,500	4,260	0.40	0.31	0.86	0.92	5.7x	7.4x	2.7x	2.5x	14.0%	1.3x	1.4x	3.9x	4.1x
Verizon	3	VZ	$25.08	71,654	136,243	74,590	83,030	23,990	27,160	2.49	2.71	1.07	2.05	10.1x	9.3x	23.4x	12.2x	6.9%	1.8x	1.6x	5.7x	5.0x
Alaska Communications	2	ALSK	$9.23	409	945	379	390	129	138	0.25	0.47	1.24	1.39	36.9x	19.6x	7.4x	6.6x	9.3%	2.5x	2.4x	7.3x	6.8x
CenturyTel, Inc.	2	CTL	$29.50	3,077	6,075	2,603	2,581	1,258	1,223	3.29	3.24	5.20	5.25	9.0x	9.1x	5.7x	5.6x	9.5%	2.3x	2.4x	4.8x	5.0x
Cincinnati Bell	2	CBB	$1.94	482	2,458	1,416	1,468	484	508	0.43	0.53	0.62	0.71	4.5x	3.7x	3.1x	2.7x	NA	1.7x	1.7x	5.1x	4.8x
Frontier Communications	2	FTR	$7.71	2,474	7,045	2,266	2,258	1,240	1,237	0.64	0.67	1.45	1.45	12.0x	11.5x	5.3x	5.3x	13.0%	3.1x	3.1x	5.7x	5.7x
Consolidated	2	CNSL	$9.48	280	1,151	423	421	181	183	0.70	0.86	2.19	2.46	13.5x	11.0x	4.3x	3.9x	16.4%	2.7x	2.7x	6.4x	6.3x
Embarq	1	EQ	$29.74	4,425	10,345	6,209	6,004	2,659	2,622	5.31	5.45	6.31	7.07	5.6x	5.5x	4.7x	4.2x	9.2%	1.7x	1.7x	3.9x	3.9x
Fairpoint		*FRP*	*$4.51*	*401*	*2,731*	*1,454*	*1,440*	*560*	*555*	*0.50*	*0.47*	*2.23*	*2.18*	*9.0x*	*9.6x*	*2.0x*	*2.1x*	*22.8%*	*1.9x*	*1.9x*	*4.9x*	*4.9x*
Iowa Telecom	3	IWA	$14.88	478	998	245	254	129	131	0.82	0.82	2.06	2.20	18.1x	18.1x	7.2x	6.8x	10.9%	4.1x	3.9x	7.8x	7.6x
Otelco	2	OTT	$10.15	134	291	71	71	34	33	0.09	(0.03)	1.76	1.76	NMF	NMF	5.8x	5.8x	16.6%	4.1x	4.1x	8.5x	8.8x
Windstream	2	WIN	$7.66	3,237	8,547	3,231	3,263	1,678	1,686	1.09	1.14	1.67	1.70	7.0x	6.7x	4.6x	4.5x	13.1%	2.6x	2.6x	5.1x	5.1x
													Mean:	11.7x	10.0x	7.2x	5.6x	11.5%	2.4x	2.4x	5.7x	5.6x
													Median:	9.0x	9.2x	5.3x	5.3x	10.9%	2.3x	2.4x	5.1x	5.0x
Competitive Local Exchange Carriers (CLEC's)																						
Cbeyond	3	CBEY	$9.32	276	233.1	351	450	62.0	77.6	0.15	0.29	(0.34)	0.07	62.1x	32.1x	NMF	NMF	NA	0.7x	0.5x	3.8x	3.0x
Cogent	2	CCOI	$4.12	187	359	216	255	64	84	(0.56)	(0.03)	0.51	0.96	NMF	NMF	8.1x	4.3x	NA	1.7x	1.4x	5.6x	4.3x
ITC Deltacom		*ITCD*	$1.35	*109*	*355*	*507*	*520*	*84*	*93*	*(1.04)*	*(0.47)*	*NMF*	*NMF*	*NMF*	*NMF*	*NMF*	*NMF*	*NA*	*0.7x*	*0.7x*	*4.2x*	*3.8x*
TW Telecom	2	TWTC	$5.09	759	1,810	1,164	1,232	394	422	0.08	0.24	0.23	0.62	63.6x	21.2x	22.1x	8.2x	NA	1.6x	1.5x	4.6x	4.3x
Paetec	3	PAET	$1.10	190	991	1,623	1,733	247	286	(0.25)	(0.02)	0.19	0.37	NMF	NMF	5.8x	3.0x	NA	0.6x	0.6x	4.0x	3.5x
XO Holdings		*XOHO*	$0.18	*33*	*545*	*1,450*	*1,500*	*115*	*125*	*(0.45)*	*(0.40)*	*NMF*	*NMF*	*NMF*	*NMF*	*NMF*	*NMF*	*NA*	*0.4x*	*0.4x*	*4.7x*	*4.4x*
Level 3	4	LVLT	$0.75	1,169	7,218	4,295	4,315	983	1091	(0.32)	(0.22)	(0.10)	0.04	NMF	NMF	NMF	NMF	NA	1.7x	1.7x	7.3x	6.6x
													Mean:	62.9x	26.7x	12.0x	5.2x	NA	1.0x	1.0x	4.9x	4.3x
													Median:	62.9x	26.7x	8.1x	4.3x	NA	0.7x	0.7x	4.6x	4.3x
Cable Providers																						
Cablevision		*CVC*	$14.02	*4,135*	*14,755*	*7,158*	*7,775*	*2,284*	*2,470*	*0.63*	*1.13*	*1.70*	*2.63*	*22.3x*	*12.4x*	*8.2x*	*5.3x*	*NA*	*2.1x*	*1.9x*	*6.5x*	*6.0x*
Charter Communications		*CHTR*	$0.40	*149*	*20,553*	*6,526*	*7,130*	*2,316*	*2,567*	*(2.93)*	*(2.28)*	*NMF*	*NMF*	*NMF*	*NMF*	*NMF*	*NMF*	*NA*	*3.1x*	*2.9x*	*8.9x*	*8.0x*
Comcast	3	CMCSA	$13.07	38,818	69,269	34,302	36,637	13,254	14,291	0.91	1.08	0.88	1.06	14.4x	12.1x	14.9x	12.3x	1.9%	2.0x	1.9x	5.2x	4.8x
General Communications		*GNCMA*	$5.69	*300*	*1,019*	*561*	*616*	*168*	*192*	*0.25*	*0.45*	*NMF*	*NMF*	*22.8x*	*12.6x*	*NMF*	*NMF*	*NA*	*1.8x*	*1.7x*	*6.1x*	*5.3x*
Knology	2	KNOL	$4.21	150	726	412	432	137	150	(0.24)	0.14	1.18	1.53	NMF	NMF	3.6x	2.8x	NA	1.8x	1.7x	5.3x	4.8x
Mediacom Communications		*MCCC*	$3.27	*318*	*3,525*	*1,396*	*1,481*	*506*	*541*	*(0.36)*	*0.16*	*NMF*	*0.43*	*NMF*	*20.4x*	*NMF*	*7.6x*	*NA*	*2.5x*	*2.4x*	*7.0x*	*6.5x*
RCN	3	RCNI	$5.40	202	881	734	761	188	206	(2.20)	(2.21)	0.44	0.87	NMF	NMF	12.3x	6.2x	NA	1.2x	1.2x	4.7x	4.3x
Time Warner	2	TWC	$18.30	17,899	30,513	17,300	18,606	6,259	6,885	1.15	1.21	1.61	1.13	15.9x	15.1x	11.4x	16.2x	1.1%	1.8x	1.6x	4.9x	4.4x
													Mean:	18.8x	14.5x	10.1x	8.4x	0.0x	2.0x	1.9x	6.1x	5.5x
													Median:	19.1x	12.6x	11.4x	6.9x	0.0x	1.9x	1.8x	5.7x	5.1x

(1) FCF Per Share is defined as EBITDA, less cash operating taxes, less capital expenditures, less changes in net working capital, less tax-effected interest expense; all divided by diluted shares outstanding

Bold names denote Raymond James coverage under Frank Louthan, with RJA ratings in parenthesis.

Verizon's revenue and EBITDA includes 55% of Verizon Wireless; TWTC includes Xspedius estimates and assumes covertible debt is converted; Paetec, Consolidated, and Knology Pro forma for planned acquisitions

Source: Reuters, Raymond James Estimates, and Company Reports. Estimates for companies not covered by Raymond James are mean estimates from Reuters, RJ and company management.

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Strong Buy (SB1)................ Expected to appreciate and produce a total return of at least 15% and outperform the S&P 500 over the next six months. For higher yielding and more conservative equities, such as REITs and certain MLPs, a total return of at least 15% is expected to be realized over the next 12 months.

Outperform (MO2)............... Expected to appreciate and outperform the S&P 500 over the next 12 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, an Outperform rating is used for securities where we are comfortable with the relative safety of the dividend and expect a total return modestly exceeding the dividend yield over the next 12 months.

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